WHAT WOULD REPEALING THE DEATH TAX MEAN FOR SMALL BUSINESS?

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAX, FINANCE, AND EXPORTS

AND

SUBCOMMITTEE ON RURAL ENTERPRISES,
BUSINESS OPPORTUNITIES, AND
SPECIAL SMALL BUSINESS PROBLEMS

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WHAT WOULD REPEALING THE DEATH TAX MEAN FOR SMALL BUSINESS?

THURSDAY, MAY 13, 1999

HOUSE OF REPRESENTATIVES, SUBCOMMITTEE ON TAX, FINANCE, AND EXPORTS AND SUBCOMMITTEE ON RURAL ENTERPRISES, BUSINESS OPPORTUNITIES, AND SPECIAL SMALL BUSINESS PROBLEMS, COMMITTEE ON SMALL BUSINESS,

Washington, DC.

The Subcommittees met, pursuant to notice, at 10:05 a.m., in room 311, Cannon House Office Building, Hon. Don Manzullo [chairman of the Subcommittee on Tax, Finance, and Exports] presiding.

Chairman MANZULLO [presiding]. I call the Subcommittee to order.

Today, we start the inaugural hearing of the Tax Subcommittee on the topic of the estate tax, or as I call it the "death tax." It gives me great pleasure to co-Chair this hearing with my good friend from New Jersey, Frank LoBiondo, who was awarded the chairmanship of the Rural Enterprises Subcommittee earlier this year.

I hope I am not stealing the thunder from my colleagues, but there is a saying that there are only two certainties in life—death and taxes. This issue cruelly combines them both.

People should not have to worry about the tax collector standing outside the funeral home door waiting to collect the death tax. An estate is built up after a lifetime of savings that has already been taxed once.

Plus, with the growing stock market and burgeoning retirement plans, more and more middle-class people will soon be surprised to learn that they are part of the "super-rich." Their heirs will have to pay substantial death taxes at rates as high as 55 percent.

Today, we are focusing on the devastating impact of the death taxes on small businesses. I am going to waive the rest of this opening statement, and I would ask the rest of the members to do also out of deference to the fact that we have two members who are here on the first panel, and then, perhaps, if anybody wants to give an opening statement, they can do it prior to the starting of the second panel. I am sure that is okay with the members here.

And the testimony from the first member will be the Honorable Jennifer Dunn. Jennifer.

STATEMENT OF HON. JENNIFER DUNN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF WASHINGTON

Ms. DUNN. Thank you very much, Chairman Manzullo and Chairman LoBiondo. Thanks for holding this hearing to discuss a very popular initiative, the repeal of the death tax. I want to especially thank my colleague on the Ways and Means Committee, Mr. Tanner, for pushing this repeal as strongly as I have and for being my colleague on H.R. 8, which is the bipartisan death tax repeal bill.

Over 170 of our House colleagues have joined us on H.R. 8, the Death Tax Elimination Act, which would phase out the death tax starting in the year 2000 at five points each year, and that starts at 55 percent, but if somebody's paying the lower rate of 37 percent, we will also——

Chairman MANZULLO. Jennifer, excuse me a second. I think we have a vote. No, it is not a vote. It is only a notification of a caucus meeting.

Could you put the mike closer to your mouth, Jennifer? Thank you.

Ms. DUNN. You bet. The Death Tax Elimination Act, which is H.R. 8, a bipartisan bill, phases out the death tax by five percentage points a year over the next year. The goal, of course, is to phase this tax out completely, and, therefore, over 10 years it is only eliminated.

It has been said that only with our Government are you given a certificate at birth, a license at marriage, and a bill at death. One of the most compelling aspects of the American dream is to make life better for our children and our loved ones, and yet the current treatment of taxes on a person's life savings is so onerous that when one dies, the children are often forced to turn over half of their inheritance to the Federal Government.

Even worse, not only does this take place at an agonizing time in the life of the family, but they also have to watch their loved one's legacy be snatched up by an entity that is not known for its great wisdom for spending money, and that is the Federal Government. We believe this is wrong. We believe that you should not dishonor the hard work of those who have passed on.

According to a recent study by the Life Insurance Marketing Research Association, less than half of all family businesses survive the death of the founder, and only about 5 percent of these businesses survive into the third generation. This is terrible public policy particularly in light of the minimal amount of the money the death tax brings into the Federal Government—just slightly over 1 percent of revenues and slightly over $23 billion, according to last year's figures.

In addition, a recent joint Economic Committee study reported that for every dollar the death tax brings in, another dollar is spent by the private sector simply to comply with it, so the total impact of dollars that are taken out of the private sector that could be going to additional employment or purchase of equipment or property in the private sector, the total amount is $46 billion a year that come out of the Federal Government. You would think that a basic principle of any revenue raiser, i.e. tax, would be to raise revenues, and yet we are losing exactly 100 percent of what we bring in through compliance alone.

By confiscating between 37 and 55 percent of a decedent's estate, the Government punishes long-life habits of savings; it discourages entrepreneurship and capital formation, and it penalizes families. This is especially true, because these dollars are often the same dollars that have been taxed three, four, five times before as they go through the hands of the owner—through income tax, through capital gains, through tax on dividends, and in many other ways.

Under today's tax system—and this is really important to remember, because I am seeing it happen in my district—it is easier and cheaper to sell the business or the family farm at 20 percent capital gains than to retain it, built it up, invest in it, and try to pass it on to the family after death. You have to remember that the minimal death tax that is paid starts at 37 percent. This is not a tax that starts at zero, and so that is vitally important to remember. It is huge; far more than capital gains.

Of course, Congress has attempted to ease the burden of the death tax by increasing the personal exemption to adjust for the inflation of assets. Unfortunately, this will continue to be too little help as home values, the increasing popularity of defined contribution plans, and the trend toward more small business entrepreneurship, particularly by women, drives middle-class estates above the exemption.

Congress also tried very hard in 1997 to help small businesses by creating an additional death tax exemption for family-owned businesses. Here, too, however, is where a good idea went wrong. It became impractical in the real world. The family-owned business exemption, passed in the Taxpayer Relief Act of 1997, creates 14 new definitions in which a business must comply before it is eligible. So, it was a good idea at the time, but the exemption has proven to be nothing more than a boondoggle for attorneys and for estate tax planners. As a result, only about 3 percent of family-owned businesses and farms can qualify for that 1997 provision. I recently asked an estate tax attorney who advises 200 family-owned businesses, how many of these businesses are eligible for this exemption, and his answer "Out of 200, 10; 10 were eligible."

No amount of artful drafting will provide relief to only those Congress deems worthy. We can't continue to congratulate ourselves for legislative triumphs that just don't benefit hard working Americans. Family relationships in the private sector are much too complex for us—those of us who want to do this in the Congress—to duplicate or to reflect through Federal tax law. So, now we believe it is time to be bold.

The Death Tax Elimination Act is the right answer at the right time. The productivity of enterprising Americans and a frugal Congress intent on reducing wasteful spending has helped to produce the first budget in the surplus—or surplus budget in a generation. So, what will the Congress' response be to this surplus? Will it spend money on dozens of worthy programs that could no doubt be created to help worthy people? Or it will cobble together a complicated, voluminous tax initiative that aims to help everyone and, therefore, helps no one?

I think that we have to provide the American people with vision, and it must center on two main principles: the non-Social Security surplus belongs to the American people, and it ought to be returned to them. We must honor the institutions on which strong communities are built. I can think of no better initiative that so well defines these two principles than repeal of the death tax.

The ingredients to a successful family or business—thrift, diligence, suspension of gratification, savings—must, again, be rewarded and not taxed, and I hope that you will all join Mr. Tanner and me in this worthy fight.

I want to thank you once again for providing this forum, and we look forward to your questions.

[Ms. Dunn's statement may be found in the appendix.]

Chairman MANZULLO. Thank you, Congresswoman Dunn.

Our next witness is Congressman Tanner.

STATEMENT OF HON. JOHN S. TANNER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF TENNESSEE

Mr. TANNER. Thank you, Mr. Chairman, Ms. McCarthy. I, too, want to thank Ms. Dunn. I came to this issue really in an anecdotal way. My district is, in large measure, agricultural in its geographical makeup, and I had some friends who were farming—a father and his son. His father died, and the son had to auction the equipment that belonged he and his father, which they used in their farming operation, in order to pay the estate taxes. He now is no longer in farming, because he had to buy the equipment back, and the added debt made his farming operation no longer economically viable.

Now, this has been traditionally, I think, couched in a rich versus poor arena, and I did some further research, because I think that President Franklin Roosevelt's words were—had great meaning when he said the estate tax was an appropriate means of preventing the "perpetuation of great and undesirable concentrations of control in a relatively few individuals over the employment and welfare of many, many others." Now, I have no quarrel with the statement, but when one looks at the way the estate tax is administered and is affecting small businesses and family farms in this country, whether it be a car dealership or a funeral home or something where one has a taxable estate, but one has no money, and, therefore, when the patriarch or matriarch dies, there is a sometimes several hundred thousand dollar tax bill with no cash to pay it, in which case, the funeral home, car dealership, or the small family farmer has to sell the assets that actually enable them and the family to generate a yearly income, not to mention, I believe, a societal value is embedded in the intergenerational transfer of assets particularly small farms and businesses from one generation to the other.

But, anyway, 70 percent of all the taxable estates in this country are $5 million or less. Now, $5 million is a lot of money, but if one, as I said earlier, has assets of $3 million, all of which are tied up in the generation of yearly income, a $400,000 or $500,000 tax bill at the death of the patriarch or matriarch makes the business 100 percent tax in the case where they have to sell the assets.

In President Franklin Roosevelt's study, you might be interested to know there was an estate exemption, and in today's dollars it was $9 million. We are struggling to get from $600,000, which we went to a couple years ago, up to, in some cases, $1.3 million if the estate qualifies, and there is a lot of qualifiers to that higher number, and so I think what we have done over time is really begin to get away from the principle espoused by President Roosevelt when—as I said, I agree with the vast transfer of wealth in the hands of a few over to control the lives of the many, and I would not have any problem with a $9 million exemption as it was in his day.

Now, I don't know whether or not that is feasible, but the main point I wanted to make this morning was that this is no longer rich versus poor with 70 percent of the taxable estates at $5 million or less—and, by the way, they pay 50 percent of the entire estate tax collected. So, the estates of $50 million to $100 million to $200 million, even under our present system, it seems to me, are not—if one believes in an estate tax of some kind at some level, as a matter of public policy—it is not accomplishing what it was intended to do.

And, so I think that any consideration we could give to those people engaged in farming, small business, and even others as it relates to this tax, so that we do not force, basically, people to sell the assets that their father, grandfather, mother, grandmother built up over the lifetime of hard work—interestingly enough, you might know that some of the people who agree with this and who are as supportive of this as anyone are the so-called "greens," the environmentalists, because they have seen open spaces particularly around the urban areas of the country having to be sold at the death of the patriarch or matriarch, and had to be developed simply to pay the estate taxes. And, so when we talk about urban sprawl, when we talk about the quality, when we talk about the size of generational transfer of assets that creates family income yearly, all of that is intertwined in this issue. One would not maybe think of that at first blush, but it is true.

And, so I want to thank you all again and appreciate very much your willingness to hear us out on this and your attentiveness to this issue, which I believe is something that—an area where we ought to change the public policy.

Thank you.

[Mr. Tanner's statement may be found in the appendix.]

Chairman MANZULLO. Thank you very much.

I would like to ask a couple of questions, and then I am going to hand the gavel over to Mr. LoBiondo. I am also on the International Relations Committee, and we are having a hearing on the Kosovo so-called peace settlement. So I beg your forgiveness for leaving.

I don't think that most Americans realize that life insurance proceeds are considered to be part of the taxable estate. The problem really arises when the last spouse dies, because of the unlimited marital deduction, which is relatively new. I think about 15 years ago, Congress tried to solve this problem. There used to be a huge tax upon the death of the first spouse, then another tax upon the death of the second spouse, so the family wouldn't get hit.

In addition to your bill, there are some other bills that are floating around, one particular by Mr. Cox from California. Would you want to explain that to our forum here?

Ms. DUNN. Yes, I would be happy to, Mr. Chairman. H.R. 8 was designed to be a bipartisan bill to gradually—and we believe in a very practical way—phase out the rate of death tax, so that over a period of time the revenue losses would be gradual. For example, there is no revenue loss to the Government in the year 2000, which fits nicely into our plan not to put a whole lot of tax relief into 2000. The revenue loss begins in 2001 in Mr. Tanner's and my bill.

Mr. Cox's bill is an immediate phase-out of the death tax, total phase-out, and I happen to be on Mr. Cox's bill, because that is what I would like to do, but we were looking for a practical way to do this, and you might be interested in knowing that Mr. Cox supports the Tanner-Dunn bill as I support the Cox bill and that our colleagues are signing up on both bills. So, it is just the difference between, I believe, a practical phase-out over 10 years versus an immediate phase-out of the death tax.

Chairman MANZULLO. Congressman Tanner and Congresswoman Dunn, is there really a net loss to the economy if you had an elimination of the death tax?

Mr. TANNER. Well, of course——

Chairman MANZULLO. I am sorry, a net loss of tax revenue.

Mr. TANNER. I think there is a fiscal note of around $200 billion over 10 years. I disagree with that, but, nonetheless, that is what I have been told. There would be very little in the first two or three years. The estate tax now only collects about $23 billion a year for the Federal Government, and so if you phase it out over 10 years, you can see the small amount that we believe could be absorbed by the growth of the economy if we chose to go that route.

Frankly, the monies collected—I have seen estimates—correct me, Jennifer—but 63 to 67 cents of every dollar collected has to be expended by the Government to collect it.

Chairman MANZULLO. I know groups such as 60–Plus have put out different studies, anywhere from 50 to 65 percent. So, in your opinion, it is $23 billion each year less the 65 percent in Government expenditures——

Mr. TANNER. It wouldn't be $23 billion the first year; it would only be $23 billion the 11th year and our 10th year if, under our plan to phase it down, the first few years would be virtually nothing. If one believes, as we do, that it is a grossly unfair tax to begin with, at least in terms of how it affects those estates of $5 million or less, and if one further believes that it is an extremely arduous cumbersome tax to collect, and if one believes that the money that goes into—the time, effort, and money that goes into estate planning to avoid this tax were put into job creation and the building of the business or the family farm because you did not have to fear having to sell the assets at the death of the founder or the patriarch, then, it seems to me, one could make the argument, it may not cost anything at all.

Chairman MANZULLO. I appreciate that.

Ms. DUNN. And let me just add one thing: you have got $23 billion coming in in 1998; you have got $23 billion approximately spent just to comply with that tax in 1998; you have got another

65 cents out of every dollar, as Mr. Tanner said, being spent by the Federal Government to pull in this tax; that is a huge problem.

And I just want to give you some perspective. This death tax has been around through the history of our Nation but in very reserved ways. In the 1700's, our Government implemented the first death tax, and it was used specifically to fund a war. In the 1800's, twice, it was used—it was brought to fund wars, and after a period of no more than six years in all three of those cases, the death tax was ended, because the Government was smart enough to realize that this was not fair; it was not right, and it was not bringing in enough income to do anything major in our Government's budget. But, in 1916, when the death tax came in for the fourth time, the Government decided that hand in the pocket of the taxpayer was a pretty good deal, and it was never phased out. So, there is no reason this should have lasted as long as it has.

We understand the build-up of Government and the inclination to bring in every dollar, but the scoring that John and I worked with is not dynamic scoring. It does not take behavior into consideration and the creation of jobs that should be done with this huge private sector donation that the $46 billion, through compliance and dollars every year, is going right out and mostly out of the businesses, the pockets of the small businesses.

Chairman MANZULLO. I appreciate. Mr. LoBiondo, if you wouldn't mind chairing the meeting. I have to run to the other meeting, and you can work with other members on getting their questions too.

Chairman LOBIONDO. I will be glad to, Mr. Chairman. Thank you.

Chairman MANZULLO. Thank you.

Chairman LOBIONDO [presiding]. Okay, I want to thank Chairman Manzullo for jointly hosting the meeting and to our two colleagues.

I just have one question for you. Do you have any idea how Chairman Archer is viewing this? Has he said anything optimistic or—for either one?

Ms. DUNN. Chairman Archer is a supporter of death tax relief. Obviously, we have to put a lot of tax relief into a very small amount of money over the next couple of years, because we choose to set aside the Social Security surplus.

Chairman Archer, though, recently did a poll on the death tax, and he was most startled at the results and is looking very favorably at this. He asked people in the most negative way possible what they thought of the death tax, and the question was, basically, "Even you knew billionaires might be getting some advantage, would you favor a repeal—a rate reduction repeal of the death tax? And the answer was 30 percent of the said, "No;" 64 percent of the folks said they did favor a repeal of the death tax, and he is looking very seriously at this.

I will also say, Mr. Chairman, that Chairman Archer has had much more interest shown by Members of the Congress—over 170 people, our colleagues, have signed on this bill, and over 70 national organizations have come to speak and testify and so forth with their interest in this bill—everybody from the Farm Bureau to NFIB.

Chairman LOBIONDO. Did you say 70—7–0—organizations or 7?

Ms. DUNN. Over 70 organizations.

Chairman LOBIONDO. Seventy; that is what I thought. Okay, thank you.

Any other members have questions? Congresswoman McCarthy.

Mrs. MCCARTHY. Thank you, and I appreciate your testimony.

I come from Long Island where we have a large number of small businesses, and what we are seeing constantly are more women who have worked very hard to build up their small businesses. A lot these women are single; this is their only business, and they are raising their families, and certainly we are hearing the complaints that if something happened to them, all of their hard work would certainly go down the tubes as far as leaving something to their family.

Michael Forbes who is out on the east end, which would be considered a rural area—although some of us that are out there now don't think its rural anymore—we are seeing our farmers leave; we are seeing them selling off now, mainly because they know if they die, there is not going to be anything left for their families to continue going with the estate taxes as it goes.

So, I think that this is an issue that is extremely important for small businesses, our farmers, and it is something that we should be addressing. I happen to think it is totally unfair, and, obviously, hopefully, we will get it through this year, and I hope Congressman Archer will allow it to come through, because I do think it is important.

Small business is the backbone of our country today, and—they are—and we certainly here on this Committee will try and do whatever we can to help them, and I think that is important.

I was curious, has the Joint Committee on Taxation scored your bill?

Ms. DUNN. They have, and, as Mr. Tanner said, we have some disagreement with them, because it is not dynamic scoring, and it doesn't really register the impact of the dollars taken out of the private sector. Our bill is scored at $44 billion over 5 years—$44 billion over 5; $198 billion over 10, and in the year 2001, which would be the first impact of our bill, the impact would be $4.1 billion. Right now, in the year 2001, we are expecting to have something like $11 billion available for tax relief. So, $4.1 billion in 2001 and gradually, of course, it would increase.

Mrs. MCCARTHY. Has anyone actually looked at the difference between—all right, we are going to try and take away the estate tax—but has anyone looked at the other side of it, if these businesses continue to stay in businesses, whether they are farms or small businesses, on what they are paying into taxes, and wouldn't that almost even it off?

Ms. DUNN. Yes.

Mr. TANNER. That is what I tried to argue a few minutes ago or state, Ms. McCarthy. I see in west Tennessee the amount of effort that goes into the planning and so on to avoid the tax. I see farms being sold at the capital gains rate of 20 percent before the death of the founder—if we could say that—to avoid a 55 percent rate, and so I just believe that the scoring, although it may be technically correct from the standpoint of simple arithmetic, I think it fails to realize the realities involved in the collection of this tax.

Ms. DUNN. And let me just add, Mrs. McCarthy, what often happens when the owner dies suddenly and hasn't really completed the turnover process and so you have got a huge death tax—55 percent—on the value of a small business or a small farm, and the young people, the children who—the loved ones who inherit these properties can't afford to pay that huge, onerous burden, because they don't want to break up the family farm or sell the implements. Big corporations move in; they can shoulder the burden. They often take over a small community newspaper, for example, and so there is a greater loss to the community, institutional loss—public service announcements from a newspaper, the employment by the owners of the small business; you can go on and on and on. Often these corporations close down the small operation; move them someplace else, so there is a true loss to the community when a small business closes down.

You mentioned women starting small businesses. Right now, they are doing that at twice the rate of men. There is a huge exodus from corporate lives into entrepreneurial small businesses that are often owned individually by these women. And, so they are hit at their death when they wish to put everything they put their hearts and souls into developing and the savings and the risks they have taken in taking loans, they are going to sell it before they die, because 20 percent capital gains is less than 55 percent death tax.

Mrs. MCCARTHY. One of the things that I have noticed too—and probably Congressman Forbes will address this—I have gotten to know a lot of farmers out in his area. They have been there for a couple hundred years actually, and they have worked the farms really hard, but because it is a tourist area now, the land is worth more than they ever thought they could ever get. And being an environmentalist, I don't like seeing 300 homes going up onto a farm, and nobody is even living there. Unfortunately, the consequences, in my opinion, is there is no housing out there for middle-income people anymore. If you are wealthy, you can buy an acre, which in some areas of South Hampton will go for $150,000—one acre right in the middle of a farm. The majority of people that actually live out there can't afford that, so to me it is a total injustice. We have to do what we can for them.

Chairman LOBIONDO. Thank you.

Mrs. MCCARTHY. Thank you.

Chairman LOBIONDO. Congressman Hill.

Mr. HILL. Thank you, Mr. Chairman.

I want to congratulate both of you. I am a co-sponsor of your bill. I actually have a bill, as well, that would convert the estate tax to a capital gains tax, but I don't think there is a tax that is more unfair than is the death tax.

In my previous life, however, I worked with a lot of small businesses, and I worked with them to try to help them develop strategies to avoid the death tax, and I think that in the modeling that has been used by those that are scoring this, they don't have a full understanding of just how much money gets spent on trying to avoid paying the death tax. As you know, you can set up charitable trusts and insurance trusts and generation-skipping trusts; there is all sorts of kinds of trusts. The problem that I experience working with these small businesses is that it diverted a lot of money from the reinvestment in their business. In fact, I think it is why a lot of small business owners object to the death tax is substantially because of that. They have to buy life insurance that they wouldn't ordinarily buy, which is very expensive, or professional fees for accountants and lawyers to set up these trusts.

But, also, once these assets get allocated to these trusts or the mechanism gets put in place, it often creates a real rigid environment for them to manage those business assets thereafter, because they don't have the same flexibility using those assets, because they are in a trust or they are allocated to trust or they have created a complex trust agreement.

And I guess my question is, is there some way that we can get this scored to take those kinds of things fully into consideration—their impact on revenues and their impact on the economy?

Ms. DUNN. You know, I don't think we have the answer to that. A lot of us have pushed for years for dynamic scoring or at least a combination of what we use in dynamic scoring, because to be realistic about something like this and we should provide that kind of management leadership, I think, being realistic about budgeting.

You would say that the death tax, if it were totally repealed, that the energy that would go into the economy through the abilities of the entrepreneurs and the small business people and the family farmers would be much greater and result in far more dollars in revenue going one way or another into the Government, but there is not any way we can change this right now.

I think sometimes you have to go by instinct on some of these things, so the economic growth tax relief, like capital gains and death tax, I believe, over the long-run will bring in more dollars, and they have been able to do a little bit better in capital gains projecting for the first couple of years under capital gains cuts that revenues will actually increase, and I think that is the result of experience that we have seen through the years when that really has been provided.

Mr. HILL. I think the same is true of the death tax, your bill particularly, and the fact that it is phased in I think will give us the opportunity to demonstrate that there are economic rewards to it over a period of time.

In my State, we have a lot of farms and ranches, and what people are facing is, is that if you are going to sell the farm or the ranch in order to deal with the tax question, you are a whole lot better off to subdivide it and sell it as a subdivision than you are to sell it as a ranch, because most of these—in fact, many of the farmers and ranchers in my State, if you use the income test alone, would be eligible for food stamps. They would be eligible for financial assistance. Obviously, they are not eligible because of the value of their estate, because they may have a $3 million or $4 million or $5 million farm or ranch. But it can't produce enough income for multi-generations to live off that.

But the problem is—so, the strategy, then, is that the only alternative is to sell it. So, the alternative, then, if you are going to sell it, you are better off to sell it not as a farming unit but sell it as a subdivision, and most of Montana has been broken up into 20–acre subdivisions. Even operating ranches have been subdivided in anticipation of the opportunity to do that, and that is a great tragedy. It is a great tragedy for us from the standpoint of family agriculture, but it is also a great tragedy in terms of how it is going to impact the environment as well.

You know, one of the problems I see is that a lot of businesses and farms and ranches may have a $5 million value to their estate, but they don't have any money. In fact, some of the most successful small businesses don't have a lot of cash around; they don't have a surplus of liquidity. They are pouring that money back into their business, and what I see when they reach a certain point, from my personal experience, is that they start diverting that capital to reinvest in the business and create more jobs and investing into mechanisms to avoid taxes and particularly this tax.

And I just know intuitively and from my personal experience—although it is anecdotal—that if we get rid of this tax or get it down to a level where people think it is fair and manageable, that we will see these small businesses reinvest in their businesses and grow those businesses much larger, and I think we will keep those within a family, which I think creates more competition and more opportunity.

I just thank you both for your work. If there is something that we can do to help in trying to get a more scoring of that, I would certainly offer my help, and I am hopeful that Mr. Archer will include your bill or something like it in any tax relief package.

Thank you, Mr. Chairman.

Chairman LOBIONDO. Thank you, Congressman Hill.

Let me ask Congresswoman Dunn and Congressman Tanner, how are you on time? I believe more members might want to ask questions. Are you okay a little while longer?

Okay, I will ask Committee members to keep in mind that our colleagues have a limited amount of time and that we do have a second panel.

Now, I would ask Congresswoman Christensen, do you have any questions of the panel members?

Ms. CHRISTIAN-CHRISTENSEN. Thank you, Mr. Chairman. Could I just pass until I find out what questions have been asked?

Chairman LOBIONDO. Sure. Congressman Baird, do you——

Mr. BAIRD. Congressman Tanner, Congresswoman Dunn, it is great to see you both here, and I appreciate your work on this bill.

I wanted to echo your comments earlier. I am proud to co-sponsor it and for many of the reasons you have mentioned. Two particularly that stand out for me are environmental protection. In my district, we have a lot of family foresters who have been very good stewards of the land over many years. They have got forests that are 40, 50, 60 years old. Suddenly, the owner—father, mother—passes away, and instead of being able to wait the next 20 years to let the forest reach full maturity, they are virtually forced to clear cut doing just the exact opposite of what we want them to do for the environment.

Similarly, for me, it is a pro-labor issue. We have a number of mid-size businesses that have more capital assets or more assets than would meet the exclusion, and if they are forced to sell, they often have very good contracts with labor; they pay family wages; they are good community stewards; they help with charities, et cetera, and they are forced to sell when one of them dies rather than pass it on to their kids who would presumably keep the same community tradition.

The only possible hesitation I have about this issue—and I really would appreciate sincerely your addressing it—the issues I have just addressed have to do with family farms, family businesses, local community ownership. That, to me, conceptually, is somewhat different than someone who is passing on an enormous stock portfolio that may not necessarily have the job or environmental benefit locally, and I am aware that there are some other bills that seek to distinguish between assets—concrete physical assets versus equities, et cetera. Could you share your thoughts on that in terms of how we might work that out or what the pros and cons are from your perspective?

Mr. TANNER. Well, as you know, I had quoted President Franklin Roosevelt in my opening statement about—that it is undesirable in this country. I mean, the reason that we had an estate tax to begin with was because people saw the UK and saw where some fellow acquired great wealth in 1450 and 23 generations later none of them had worked or contributed to the economy or to the society and so on, and we didn't want that in this country, and every generation stands on its own, and so forth.

When President Roosevelt made that statement, though, the exemption in that day's dollar terms was about $9 million. Well, if you all could help us to get to $9 million and a capital gains right above that, then I have no quarrel at all with that, because I think President Roosevelt's words have a certain truth in them.

We are concentrating on, in our bill, trying to reduce the rate gradually, so that as this thing matures, we can say that at some point in time maybe we ought to look at flipping over to a capital gains rate above some meaningful number that will address the sorts of things we are talking about with family farms and small businesses. I mean, I don't have any problems if someone has got several billion dollars paying a little something to help out with the purchase of aircraft carriers and tanks and highways and all the things that we need. I don't have a problem with that, but where do you start with that, you know?

Ms. DUNN. I do think I agree with Mr. Tanner. You have got a real definition problem when you come into a situation like that. If you are talking about a rich individual, what is rich? Is it somebody like Helen Anderson in my district in Northbend, Washington—that you are familiar with, Mr. Baird—who did exactly run into the situation you described—inherited a large piece of timber property from her father that had never been cut, and it was open to people wandering through the trails and birds and things and animals living in it and people driving by and seeing how pretty it was. Well, she had to literally cut down all the second growth timber on her property—mow her piece of property to pay what amounted to $1 million, and it was all gone, because she had to pay the CPAs and the lawyers and the estate tax and then the Federal death tax. So, the community was left bereft after that happened. That is not what we want to see. I know that is not what you want to see with your two particular areas of interest.

But, I mean, how do you define wealth? Is it somebody who owns a couple of Taco Bells? So, that is the problem that you run into, and I think earlier, folks who were the Fathers of our country and later on who ran our country very well realized that because this was an excessive almost obsessive tax, to tax the same dollar the third or fourth time, it really wasn't fair, and it really hurt the growth of the economy. I think we can justify this kind of tax relief.

Mr. BAIRD. I am not referring so much to wealth, Congresswoman, I am more—because I agree with you entirely. That is the problem is we have set the cap, whatever we call wealthy, then people who are asset wealthy, then, are forced to sell their assets—but more in terms of concrete, physical assets—farms, forests, manufacturing qualities versus a huge investment equity portfolio that doesn't necessarily have local ownership. Is there a way we can address that or is that also—?

Ms. DUNN. You know—and excuse me for interrupting—but if you leave those folks out, those folks aren't going to—I mean, first of all, if they have big dollars and assets like stocks and bonds, they are going to figure out how to use a CPA and lawyer to get around the death tax, but, number two, what will happen is behavior will again change, and if there is no death tax on those other entities, that is where they will put their investment. So, why do you want to change the balance of the whole economic market by not including everybody and allowing the market to work?

Mr. BAIRD. Thank you. Thank you, Mr. Chairman.

Chairman LOBIONDO. Congressman Toomey.

Mr. TOOMEY. Thank you, Mr. Chairman.

I would like to start by commending my colleagues for their tremendous work on this. I am a proud co-sponsor of your bill, and I think that you make a very compelling case that the death tax is one of the most ridiculous and unreasonable features of a tax code that is riddled with ridiculous and unreasonable features, and I would further point that I think you can make a very strong principled argument that the multiple layers of tax on the same income, of which this is sort of the crowning pinnacle after a lifetime of paying taxes, makes for a strong case to do an across the board elimination rather than targeting different income groups or asset classes, in my opinion.

I have two specific questions for you. Earlier, if I recall, you mentioned that the estate tax collects about $23 billion a year, and my question is, in light of the very large percentage of costs that go to collecting that, is that a net number or a gross number for the Federal Government? In other words, after all the collection costs are incurred, does the Government net $23 billion?

Mr. TANNER. Gross.

Mr. TOOMEY. That is a gross number. So, if you do the only reasonable calculation and net out the cost of acquiring that $23 billion, the Federal Government is left with $7 billion, $8 billion, something on that order.

Ms. DUNN. Yes, and the private sector is depleted of 100 percent of what is produced by this tax——

Mr. TOOMEY. Right.

Ms. DUNN [continuing]. Because that is what the compliance costs are.

Mr. TOOMEY. Sure, and totally separate and apart from all of the costs in the private sector and the costs of the economy and all of the perverse incentives it creates, the Federal Government only manages to net $7 billion or $8 billion.

My second question is, you mentioned that the Joint Committee on Taxation scored your bill as costing the Federal Government $44 billion over 5 years, if I recall correctly. Is that a net number or is that a gross number?

Ms. DUNN. Again, gross.

Mr. TOOMEY. That is a gross number. So, in fact, we can be sure that the Federal coffers will diminish by much less than $44 billion, aside from the whole positive scoring of the effect on the economy?

Ms. DUNN. You are absolutely right. It is what one of the congressmen was saying earlier; that is exactly right.

Mr. TOOMEY. Okay, thank you.

Chairman LOBIONDO. Congressman Phelps.

Mr. PHELPS. Thank you, Mr. Chairman, and I, too, want to commend you both for your leadership on this particular issue. It is gratifying for a new member to come in and start a session with such legislation that benefits all—working people.

Mine is probably more of a comment than a question, real quickly. Coming from the State legislature in Illinois and serving for 14 years there and realizing that facing revenue questions are very much a challenge, the thing that I—I know that before we get through this year, this session when the budget is formed, hopefully, there will be a bipartisan agreement on how we do that or it probably won't be done. If we either give across-the-board tax cuts and even agree on target tax cuts or a combination of both or whatever comes out, I guess my concern is—even though I am cosponsor of this bill, and I know probably all of us will be or are already and see its merits for what it is—but I am concerned as a new member and being raised to be responsible for my own budget in my own life, knowing that it takes revenue to operate and whoever's forecasts are accurate or not that we study here and what it means 10 years on down the road, it will have an impact. Once we have a reliance on revenue and it is taken away, the question comes in my mind, will this body—does Congress have the will and can we work in a bipartisan manner to either identify replacement revenues or to reduce accordingly?

So, I guess, what I am saying, I think this action is incumbent on all of us to honestly try to work together in doing one of either or a combination of both, and the good economy helps take care of a lot of those problems; I realize that. But just as a new member that is probably naive in a lot ways of how we come about working in this manner to be sure that we don't just depend on good economic growth and pretend it is always going to happen, and prepare for a rainy day, because as we all are co-sponsors or at least support this concept, we are going to also be providing money for small business grants, loans that will be guaranteed by the Government, and that is taking from this column away from what we would like to do in terms of being fiscal responsible.

So, the fiscal responsibility really comes to the heights when we start—although this tax, obviously, it is recognized it should—and it doesn't make sense—it should go away, but I would hope that I am part of a Congress in his first term that would say "Let's us proportionally act if we are going to pass measures like this on all the other ramifications of the budget, such as our military spending, everything else that we are debating right now. Just a comment as a new member, thank you.

Chairman LoBiondo. Okay, thank you. Congressman Forbes.

Mr. Forbes. Thank you, Mr. Chairman, and I appreciate this joint Subcommittee hearing on a very important issue, and thanks to both of you for your leadership on this issue, and I am proud to also be a co-sponsor of the bill. In fact, I have co-sponsored every bill that would eliminate the death tax that I could find in this Congress and in the last with the hope that ultimately we will get there, and thank you again for your leadership.

I want to also thank the chairmen for what I see in our upcoming panel. There are two of the four witnesses are from Long Island, New York, and I wouldn't want to suggest that we have a disproportionate problem in New York with the estate tax, but I certainly appreciate the fact that we have some folks from Long Island who are going to be able to speak to it, and, Ms. Kaplan, when she comes up, I know in her testimony, she had noted that it is not corporations, it is not small corporations, it is families that you have referenced that pay this tax.

In my old life as the regional administrator of the Small Business Administration, I met too many people who had to cash in a lifetime investment to pay those taxes. Their families, their parents had built the business and saw it lost, because Uncle Sam had to get that pocket full of change, and, ultimately, they lost their businesses, and I have met too many local farmers on Long Island. We have precious few farms left, very important farms, and, singlehandedly, the death tax is leading to the elimination of those family farms, and so I, again, thank you for your leadership and hope and pray that we can get a bill to the floor and passed and ultimately to the President that he would sign.

I just have one question—if you can address this, I don't know—in putting together your legislation, were you able to come upon any information about estate planning and just how many small businesses may actually be involved in estate planning to mitigate or soften the impact of the death tax? I would suggest that a lot of small businesses, frankly, are marginal operations, and they are living day-to-day and to spend a lot of money on estate planning is sometimes a luxury they just can't afford, but has there been any information accumulated in regard to estate planning?

Mr. Tanner. First, let me say that I tried to masquerade myself as being from Long Island, but my accent, I am afraid, gave me away. [Laughter.]

Mr. Forbes. We welcome you as part of Long Island.

Mr. Tanner. One runs into attorney-client privilege. Ms. Dunn and I had a bill last year to extend the privilege, actually, of taxpayers or to put the privilege of privacy into the taxpayer rather than the tax preparer, and so I don't know any way one could reasonably get an accurate count of how small businesses have consulted their attorney or their CPA in terms of some sort of estate planning. I know that a prudent businessman who had the drive, initiative, and good sense to build a business that became a taxable estate, would probably consult someone during the course of his life or her life, and so I would just guess that it would be very substantial.

Someone else made a comment, this is particularly important to minorities, women, to first generational founders of businesses that make it, and there is societal value here, a matter of public policy notwithstanding, all of the things that we believe are wrong with the collection of it and the cumbersome nature of it and the unfairness, and so on, and so I just think it is good public policy that we take this up, and I appreciate what Mr. Phelps said, because he and I worked together on a lot of the budget matters when we talked about paying off the debt and being financially responsible and so on, but I think this is a tax that is clearly counterproductive and is not good public policy, and that is why I am pleased to join Ms. Dunn on this and other bills we have collaborated on in the past.

Ms. DUNN. Mr. Forbes, when I used the figure that $23 billion was spent in compliance to bring in $23 billion, the dollars, by the way, were a little less than that in what this tax brought in before last year. Last year, it moved from about $20 billion up to $23 billion last year, but $23 billion buys a lot of CPAs and lawyers, and that is really the question we are asking, and that is an investment that would be much better served to go into employment in a community and the build-up of a small business.

Mr. FORBES. Thank you, Mr. Chairman.

Chairman LOBIONDO. Congressman Udall.

Mr. UDALL. Thank you very much, Mr. Chairman. First of all, let me thank Congressman Tanner and Congresswoman Dunn for their leadership on this issue. Clearly, we have a very difficult situation for small businesses and family-owned operations, and I think, Congressman Tanner, your tale of the Markum family is a very telling one.

I am wondering how many family farms or family-owned businesses fit into the same category as the Markums—as you have described, in the range of $1.3 million to whatever size you would reasonably consider a small, family-owned business, and what does your bill do specifically for them? Either one of you may answer this.

Mr. TANNER. Approximately 70 percent of the estate tax returns are filed on estates of $5 million or less, and so 7 out of 10 would be in the range up to $5 million. Certainly, the small family farms and the anecdotal illustrations that have been talked about this morning would probably fall within that, and so I don't know.

As Ms. Dunn said, we are reducing the rate in this bill over the next 10 years so that we can hopefully get it passed and absorb the revenue loss, and, actually, we believe as we get into the bill three or four, five years down the line, people will see the wisdom of it as behavior changes and more and more effort goes into job creation and growth of the business than it does into figuring out a way to avoid the estate tax and selling off of all of the open space around the urban areas like Long Island that has been talked about.

Mr. UDALL. Thank you. Thank you very much. Thank you, Mr. Chairman.

Chairman LOBIONDO. Thank you. Congressman DeMint, do you have any questions?

Mr. DEMINT. Thank you for the work on this, and we have heard so many good things about it. Help us understand the objections that we are going to run into. Who is opposed to this and what is the opposition saying about this bill?

Ms. DUNN. Is it mostly a lack of understanding about what death tax really does and whom it affects that is creating the opposition. You will hear, for example, this is just a way to give tax breaks to your rich friends, and we have talked about all our rich friends today—the farmers, the small business people, the people that own a couple of 7-Elevens or a Taco Bell—and, so what is the definition of rich these days? People want to have more and more control over their own funds now, and the Government, in this case, is becoming an enemy instead of a partner of the private sector and the small business solutions. So, those who have not heard the real information about the effect of this tax, maybe those who believe that small business and farms aren't necessarily the core of what makes this Nation great, those are the complaints that I hear about it.

Mr. DEMINT. So, you think it is more, really, misinformation or just a lack of information at this point than true objections to the concept?

Ms. DUNN. Yes, and I think—one other statement I would make—because Mr. Phelps, I guess, has just left—but he made an interesting comment, something I didn't really understand until a couple a years ago: when you have tax relief, you lose revenues, and that means you lose certain programs that are very important to all of us, but it is important for him and others to understand that tax relief in our budget process requires cutting, in some way, dollars from other areas, and the only way you can provide tax relief is either to cut loopholes—we have talked a lot about corporate loopholes—close corporate loopholes or to take entitlement cuts, and so they have to be paid for—tax relief has to be paid for in these two ways.

This year, for the first time—and so you see the Ways and Means Committee cutting a lot of corporate aid, and you will see loopholes being closed, and that is what can be used to pay revenues, and it needs to be offsetting—this year, though, for the first time, we made an adjustment in our process of providing tax relief under the Pay Go system. We said that if there is an increase in the non-Social Security surplus in July when CBO comes back with its new surplus projections, those dollars must go either to tax relief or debt reductions. So, there are some additional dollars potentially there for tax relief, but tax relief is always paid for.

Mr. DEMINT. Thank you.

Chairman LOBIONDO. Thank you. Congresswoman Christensen.

Ms. CHRISTIAN-CHRISTENSEN. Thank you, Mr. Chair, and I want to also welcome our colleagues here this morning.

Mr. Tanner, you said that the proposal is important to minorities and rural businesses, and I don't disagree with that. I am just not sure about eliminating the tax altogether. And you have also used the $9 million in the time that I have been here in the Committee hearing as a place at which you would consider setting the limit.

I wonder if you consider exempting the estates somewhere around $6 million and maybe lowering the rates as an alternative as well?

Mr. TANNER. We can talk about that. As I said in my statement, $9 million was the dollar figure when President Franklin Roosevelt with which I agree and which I read earlier, and an answer to a question over here, to some degree, it is not offensive on the transfer of vast degrees of wealth, I think, for those people to be asked who have really received the most from this system to help pay some of the common obligations we have as a Nation, whether it be interstate highways or aircraft carriers or whatever it might have to be. That is not what we are talking about, at least not what I am talking about when I talk about the estate tax relief. The $9 million figure was just a figure that would relate to today's economy.

What I think we ought to concentrate on is, one, the unfairness of it, and even in the case of vast amounts of wealth, one could argue that it is really unfair, because, theoretically, all of this money has been taxed during one's working lifetime, and one gets into how many times does the Government tax? I really believe 55 percent, which is the top rate, is unfair in the extreme just by virtue of the fact that the Government takes more than half of it. I am not one who thinks that they shouldn't help out in some respect but not at that rate no matter who they are.

Now, on the other hand, if we could get some meaningful relief as a matter of public policy so that the green spaces around urban areas are not having to be sold for development and subdivisions and they can be kept as farms or forests or whatever they are, and if we could get some relief to small business owners so that all of the energy, money, and expense that goes into trying to figure out how to plan one's estate could go further into job creation and the expansion of that small business not to mention the societal value of the generational transfer of one's work product of one's life to one's children or grandchildren, I just think as a matter of public policy, this needs to be looked at carefully.

Now, as far as what we could do, I think you are into a legislative decision there. How do you get 219 votes? Is it $6 million or is $4 million or is $10 million or is to eliminate it or take it down to the capital gains? I mean, that is when you have got to figure out how you get 219 votes.

Ms. DUNN. And I will just say, I am a proponent of rate reduction, because that is the way you phase this tax out for all time. I want to see this tax gone. It is unfair; it is onerous; it comes at the worst time in a family's life; it is a tax on property that has, in one way or another, paid taxes three or four times before.

We did some work on the unified exemption in 1997. In that bill, we took the current unified exemption, which was $600,000 for a property, and we raised over a period of 10 years to $1 million. So, by the year 2007, it will be $1 million. And then you hear Congressman Tanner saying that under Franklin Roosevelt's terms of office in the 1930's, it exempted $9 million, so whose—where is—it is a subjective thing. I think that rate reduction, which really phases this thing out, is the way to go. Otherwise, you probably never will catch up in terms of indexing and particularly after a period of inflation like we have been through the last couple of decades.

Ms. CHRISTIAN-CHRISTENSEN. Thank you.

Chairman LOBIONDO. Well, I would like to thank our colleagues, Congresswoman Dunn, Congressman Tanner, for being here today, for your work on this legislation. I think, as you can tell, both from Congressman Manzullo's Committee and from my Committee, you have strong support as well as from many of our colleagues, and we look forward to seeing this legislation move ahead.

Mr. TANNER. Thank you.

Chairman LOBIONDO. I would now ask the second panel to come up and take seats at the table.

[Pause.]

Okay, I would like to welcome our second panel of visitors today. I would remind our panelists that we will be working under the five-minute rule. I would encourage you to keep your statements to that length or maybe even a little shorter. If your statements are longer, you can feel confident that your entire statement will be entered into the record as this will be considered for the future.

Our first panelist that we will hear from will be Aldona Robbins who is vice-president of Fiscal Associates and Bradley Senior Research Fellow at the Institute for Policy Innovation. Welcome, and thank you for joining us today.

STATEMENT OF ALDONA ROBBINS, PH.D., SENIOR RESEARCH FELLOW, INSTITUTE FOR POLICY INNOVATION, ARLINGTON, VA

Dr. ROBBINS. Thank you, Mr. Chairman, and thank you for the invitation to appear at this hearing.

What I would like to do is to highlight briefly a few of the major findings of a recent study that we have done for the Institute for Policy Innovation on how estate taxes affect the economy. First, estate taxes, which once were almost the exclusive headache of the super-rich, are much more likely to affect small-to medium-sized estates today than 50 years ago. In 1945, estates that were under $2.5 million—and that is in today's wealth—accounted for about one-third of all returns. In 1995, those estates accounted for 89 percent of returns. This is due in large part to the declining value of the estate tax exemption which was worth $9 million—again, in today's wealth—in 1916, and, as Congressman Tanner said, in 1930 as well versus the $650,000 in 1999. With Wall Street's spectacular performance over the last several years, it is easy to see how a middle-class family who owns a home, has IRAs, or 401(k)s could hit $650,000 pretty easily.

Second, estate taxes are harmful to the economy. High marginal estate tax rates discourage saving, about half of which is directed toward bequests, which in turn, leads to less investment, slower economic growth, and lower tax revenues. We estimate that eliminating the estate tax would ultimately produce more than $5 in extra GDP for every dollar of static revenue lost. Because the Federal Government collects about 33 cents of each dollar of extra GDP, any pay-off that is greater than 3 to 1 is going to at least pay for itself.

Third, estate taxes hit small business particularly hard. With the amount of tax owed, while it is based on asset value, the simple fact is that the tax has to be paid out of income produced by the asset. So, let us look at a family-run store that has a 10 percent return after inflation; that is 5 percent after taxes. If the owner dies and is subject to the 55 percent death tax rate, how do heirs pay the bill? Do they send 55 percent of the store's inventory to Washington? No, the Treasury doesn't accept payment-in-kind, only cash. If the heirs devote the entire 5 percent annual return, the death tax could be paid off in only 11 years. Unfortunately, Treasury wants its money now. They could go and borrow from the bank at 9 percent—that is 4.5 percent after tax—and pay off the loan in 50 years, but would the heirs want to run the store for 50 years for free? Probably not; they choose to sell.

Let us look at a small farmer who owns land near an urban area. His farm would yield a 10 percent return only when it is valued as farmland, but tax law requires that the asset be valued at its best use. That lowers the pre-tax return to 5 percent—2.5 percent after tax—and, in this case, even a 50-year bank loan won't save the farm.

The lesson to be learned here is that all taxes are paid out of income. Even if the death tax is rare event—only once in a lifetime—its average impact is very large; large enough that for some, the combined effects of income and death taxes approach 100 percent. In cases like these, the clear message is don't invest, consume.

Last, estate planning richly rewards taxpayers who can anticipate that they might be subject to the tax. Those caught off guard, often owners of small businesses, family farms, and savers who amass wealth during their lifetime, end up paying most of the tax. That may be why the largest estates, in fact, do not pay the highest estate tax rates.

Thank you.

[Dr. Robbins' statement may be found in the appendix.]

Chairman LOBIONDO. Thank you, Ms. Robbins.

What we will do is normal procedure, and we will go through the opening statements for all of the panelists, and then if there are any questions from members, we will go to them.

The next witness is H. Jay Platt, a member of the Board of Directors of the Arizona Farm Bureau Federation and representing today the American Farm Bureau. Mr. Platt, thank you for joining us.

STATEMENT OF H. JAY PLATT, RANCHER AND PRESIDENT, THE APACHE COUNTY FARM BUREAU, SAINT JOHNS, AZ, REPRESENTING THE AMERICAN FARM BUREAU

Mr. PLATT. Good morning, Mr. Chairman, members of the Committee. I appreciate this opportunity to be here and make this statement.

My wife, Trish, and I have traveled to this hearing from St. Johns, Arizona where we operate a cow/calf operation in conjunction with my two younger brothers. We are the third generation of Platts to be on our ranch, which was begun by my grandfather early this century. I also have two young sons, each of whom harbors the hope of staying on our ranch if we are not put out of business by the death tax.

Our operation consists of a cow herd of 650 mother cows and their calves. That is down from slightly over 1,000 mother cows due to drought. We run these cows on some 125,000 acres of land in two States—Arizona and New Mexico. Of that acreage, we own roughly 20,000 acres. The balance we lease from the State and from the Federal Government. Now, that may sound like a lot of acreage, and indeed it is. I would hasten, however, to point out that our operation is typical for our part of the country where some 100 acres are required to support a single cow.

My home community of St. Johns is an area of few roads and few people, located in northeast Arizona, approximately half way between Phoenix and Albuquerque, New Mexico. Ranching is the core foundation of our community and its economy. Local ranchers serve on school boards; give volunteer time to church and community service organizations: Our mayor is the local brand inspector, saddlemaker and is also a rancher. Ranchers in our community support the single hardware store, the single grocery store, and we also help to keep three gas stations in business.

If ranchers in my county, Apache County, do not survive the death tax, the nature and character of my community, of my county, and of the land itself, will be forever altered. Mr. Hill has alluded to what is happening in Montana. If our ranch is sold to pay the death tax, I can assure you that it will not be sold to another rancher: Rather, it will be cut up, carved up, into 40-acre parcels and sold as rural ranchettes to absentee owners.

We have worked hard to be good conservators and stewards of the land. It is in our best interest to do so, having a vested economic interest in how well we manage that land. An absentee owner whose ties to the land are fleeting and are recreational in nature cannot have the same interest in conversation and stewardship which we have.

I am 48 years old, and I am now impressed with the nature of my own mortality. I am planning for my death: A few weeks ago I made a 440-mile round trip drive to Phoenix, Arizona to consult with an estate tax attorney. That will be the first of many such trips which I will make. I expect to expend considerable time and resources in crafting an estate tax plan. Those are resources and time which would be far better spent on my family and on my business. I also know that if I do not do this planning, my family business, our ranch, will be sold to pay a death tax.

As I mentioned at the beginning, my grandfather started our operation some 100 years ago. We have worked hard to build a modern, efficient ranch and feel that we have been very successful in so doing. All along the way we paid taxes on what we have earned. It is difficult for us to understand why we should again be forced to pay at our deaths. It is almost incomprehensible to me that my Government would force my family to sell our ranch at my death and punish us for our success. My community, my county, my family, and indeed the land and the environment, would be better served if our ranch continues in business.

Thank you.

[Mr. Platt's statement may be found in the appendix.]

Chairman LoBiondo. Well, thank you very much, Mr. Platt, for that testimony.

Before I introduce the next panel member, I would like to also acknowledge a couple of folks from New Jersey: Peter Furey, that I have worked with for a number of years who is executive director for the New Jersey Farm Bureau and also Mr. Lou Fisher who is here with our panelist, Mr. Ruske—that I will introduce in a minute. Lou Fisher is from my district; operates Fisher's Markets, a small family business and thought it important enough today, although he is not testifying, to be here.

And the panelist that I would like to introduce is Mr. Roger Ruske. Roger owns Cumberland Nursery in Millville, New Jersey. He is a member of the New Jersey Farm Bureau, and he is also a member of the New Jersey State Board of Agriculture, and he is secretary of the Cumberland County Planning Board. Roger, thank you for joining us. Please go ahead.

STATEMENT OF ROGER RUSKE, OWNER, CUMBERLAND NURSERIES, MILLVILLE, NJ

Mr. Ruske. Thank you, Chairman LoBiondo. I have come today to wear two hats——

Chairman LoBiondo. Excuse me, just for one minute, Roger. If you could ask Mr. Platt to move the microphone over? I think those microphones will move, and then everybody will be able to hear you.

Mr. Ruske. How is that? Is that okay?

Chairman LoBiondo. That is much better, thank you.

Mr. Ruske. Okay. As I said, I have come here this morning wearing two hats. My hat is as a member of the State Board of Agriculture. I am one of eight people who are in charge and a head of the Department of Agriculture in the State of New Jersey, and I can assure you that every farmer in New Jersey—man, woman, and child—is against the estate or the so-called death tax and as a representative of all the farmers in New Jersey, I would urge you to please do away with that. That is my official hat.

The hat I am most proud of is my Cumberland Nurseries hat, and if you see my little insignia on top, it has the four generations of my family that have been in the nursery business since basically the turn of this century. I am a third generation nurseryman following in my grandfather's footsteps, and my son, Christopher, is following in mine.

Daily, as farmers and agriculturists, we must deal with the capriciousness of Mother Nature, unending Government rules and regulations, not to mention the normal problem-solving tasks involved in running any business. In my business, if one is to be successful, long-range planning is essential. The crop that I plant today may not be harvested for one to five years, so we understand what long-term and long-range planning is.

My grandfather began his nursery business in Connecticut at the early part of this century. He was a natural farmer. He always bragged he only went to the sixth grade, and that was pretty good in his day—I guess that was considered a college education today. But he was known in our town as the midnight farmer. Grandpa worked all day at his day job and worked half the night on building up his nursery. Grandpa persevered through depressions, world war; his barn burned down; Japanese beetles almost ate him out of house and home, and he earned and saved what he could during that time. And he thought that his earnings and savings would be his to do with as he pleased, and in that day age, I guess people didn't think a whole lot about the Government confiscating your property.

Later on in his life, in the late sixties and in 1970, the family finally convinced grandpa that he had to do some estate planning, and Mr. Hill will appreciate this: he chose badly for estate plans, and this I think happens way too often. After grandpa passed away, it took years for the family to settle the estate. Between IRS asking for more paperwork documentation and what-not, five years went by, and even after five years, the IRS is still gunning my mother for paperwork and a few dollars.

I called her up the other day and asked her "Mom, do you still have some paperwork? I would just like to look at it." She said after the 7-year limit or 14-year limit, whenever it was up, she destroyed it. She did not even want to be reminded again of what her Federal Government did to her.

Let us fast forward just a little bit to this generation. My wife, son, and I have 275 acres in Cumberland County, New Jersey, and I think that by most of today's standards, we are considered successful. We have a very simple business; I am a sole proprietorship; my wife and I own the property; I have one child who is in business with me. All I want to do is pass my business on to my son. My will is literally this thick, which you could solve with one sentence, "I leave it to my son." I have to set up—as Mr. Hill will again appreciate—all kinds of trusts, marital trusts. I don't even understand what half of it is, but I understand, too, that I think this bill is probably called the accountants' and lawyers' and insurancemen's full employment bill, because they love it.

But we must pass this on to my son for all the reasons you have heard about land conservation, preserving the small business, I must be able to pass this on to my son. I have to do this through estate planning. I should not have to do this. I should not have to spend my time, my money to protect my assets from my Government.

I also brought with me—and I only brought one; Louis has the other two with him—this is one section of the Federal estate tax code. I just tried to read one page and forget it. You have to be a lawyer or an accountant to understand it, but this is how complicated our laws are.

The answer to all of this: abolish the tax—I have heard so many times this morning—just please do away with it. And I am sure the reply will be from many in Government will be this is going to create a budget shortfall. Well, you want to hear about a budget shortfall, just get hit with a late frost, a hard winter, a drought, or declining market prices and disappearing customers. In 1977, 1978, in a severe winter, I lost one-third of my crops. Nobody was there to increase my taxes or anything like that so that I could make more money. I suggest that the Government live the same way that we have to live.

I thank the chairman and the Committee for having the intestinal fortitude to address this problem. Many, many people perceive this as a rich person's problem; it is not. It is an American problem, and I hope you can solve this for us.

Thank you.

[Mr. Ruske's statement may be found in the appendix.]

Chairman LOBIONDO. Roger, thank you very much for that inspiring testimony.

Next on the panel is Mr. Kevin O'Shea who is the chief financial officer of Shamrock Electric Company in Elk Grove, Illinois, and he is testifying on behalf of the National Small Business United. Mr. O'Shea, please proceed.

STATEMENT OF KEVIN O'SHEA, CHIEF FINANCIAL OFFICER, SHAMROCK ELECTRIC COMPANY, ELK GROVE, IL, REPRESENTING NATIONAL SMALL BUSINESS UNITED

Mr. O'SHEA. Mr. Chairman, ranking members, and members of the Subcommittees, thank you for the opportunity to appear here today. As stated, my name is Kevin O'Shea. I am the chief financial officer for a small electrical firm in Elk Grove, Illinois.

For the past 43 years, my father has worked to make our company a successful small business. Because of his life work, there are 120 families that can call Shamrock Electric their employer, and it is a company they can be proud of.

By profession, I am an accountant, and, as such, I generally make decisions based upon numbers, such as cash flows, capital requirements, and expected returns. When I started to plan my father's estate, I felt it would be just another exercise in number crunching, but I was very wrong.

Estate planning has nothing to do with numbers and everything to do with family. When we started planning my father's estate, he contracted cancer, and he eventually beat it, but during the time that he was suffering from cancer, I had to, on a daily basis, discuss his eventual death with him, so that we could plan for his estate. There was a sense of urgency at that time, and we needed to get it done, and we couldn't stop. Just after he got better, our industry took a downturn, and our company started having some bad years, but we couldn't let that deter us either; we had to continue with the planning process, so in the event that there was a company left, we could pay the estate taxes and pass it on to the next generation.

In addition to that, my one and only sibling, my sister, became very upset that I was put in charge of my parent's estate planning and that she was cut out of the process. The reason being that I am involved in the company, and she is not, and because of the estate planning and the need to continue our family business, we had to make the decisions and put the company first and tell her that she just had to accept what we made as the decision.

These were some very hard times for our family, and I think that this is something that is missed when we talk about revenues to the Federal Government. There are things other than money. There is family relationships, and I think this is something that I would like you to think about when it is time to case the vote on whether or not we repeal the estate taxes.

As has been said before, I think there is a misconception as to who pays estate taxes in the United States. The architects of our tax code believe that it is people that are inheriting vast amounts of wealth that have never worked a day in their life to earn that wealth. In reality, those people have liquid assets; they can set those assets up in trusts, and they can bypass the tax laws and not pay the estate taxes. People that are paying estate taxes are small family-owned businesses, and they are being devastated.

The other item is that people haven't earned the money from family business; that my parent's generation created it, and to pass it along to us is without the Federal Government getting its share of it is unfair. What I would like to say is I started in the family business when I was 14. I have been working there for 21 years now. I have held every job within that company, and from the day I started, I have prepared myself to be in charge of Shamrock Electric, and I think I have prepared myself very well, and for somebody to say I have not earned the opportunity to have that company is very insulting to me.

In 1995, I was a member of the White House Conference on Small Business. One of the top three recommendations coming out of the White House Conference was to repeal the estate taxes. That was 2,000 small business owners speaking in unison that the estate taxes are a very real problem for small business.

I would like to thank the Committee for taking a look at this problem, and thank you very much for the opportunity.

[Mr. O'Shea's statement may be found in the appendix.]

Chairman LoBiondo. Thank you very much, Mr. O'Shea.

I would now like to turn to and yield to my colleague, Congresswoman McCarthy, for introduction of a guest that she has from her district.

Mrs. McCarthy. Thank you, Mr. Chairman. I would like to introduce Ms. Kaplan. She is a reputable small business owner in the health profession who runs the business with her son in Great Neck, New York. She brings an interesting perspective before this Subcommittee on the impact of the estate tax on the health care industry. Thank you for traveling from—everyone thinks because we live on Long Island, we get here so easily. It is short, but, let me tell you, the planes are horrible. [Laughter.]

But, anyway, thank you, Arlene, and I am looking forward to your testimony.

STATEMENT OF ARLENE KAPLAN, HEART-TO-HEART HOME HEALTH CARE, GREAT NECK, NY, REPRESENTING THE NATIONAL ASSOCIATION OF WOMEN BUSINESS OWNERS

Ms. Kaplan. Thank you. Good morning, Mr. Chairman and members of the Committee. My name is Arlene Kaplan, and I am the CEO and founder of Heart to Home, Heartland on the Bay, and Workplace CPR. These are companies that operate on Long Island in New York.

I opened my first business about 15 years ago. We provide health care services from all of our companies. I have about 70 employees; about half of them have been with me for over 5 years. I am also on the Board of Directors of the National Association of Women Business Owners.

I am not a tax expert, unless I qualify, because I pay lots of taxes—personal income tax, corporate tax, and employment taxes. I am here before you to ask if I have already paid taxes on everything I own while I am alive, why do I have to pay taxes on these things when I am dead? Now, I don't mean to be flip, because the circumstances are very serious. I am just expressing my frustration with a tax situation that seems to have gone awry.

The current estate, or death taxes, as it is now known, was initiated in 1916 to fund World War I. It was maintained in the tax code through the twenties and thirties to help prevent the concentration of wealth. Since that time, anti-trust laws have eliminated these concerns, but, to date, the estate tax remains in tact.

I would like to go back before World War I to the turn of the century, so that you can know me a little bit better and so that you will know that there are probably millions of people like me. Three of the four of my grandparents came to this country before the turn of the century, and one came just after. They all came from the area known as the Pale, the area between Russia and Poland. The children were born here, and all of them got at least a high school education; two of them even went to college. When my grandparents died, there was some small amount of money left to the children and grandchildren. The total from both sides probably didn't amount to $10,000. When my father died, he had already distributed his money to his children, his grandchildren, and his great-grandchildren. The total he gave out was under $100,000; nothing of concern to the IRS.

Now, we fast-forward to me. A number of years ago I was widowed. I eventually remarried and then came an awakening. I went to a lawyer to do a prenuptial, because that is the thing you are supposed to do. Now, I have nothing against lawyers; my company employs lots of them. We have a corporate lawyer, a tax attorney, an employment attorney, a regulatory attorney, and a real estate attorney. Now, I have a death attorney. My feeling is that when I am on my deathbed, a lawyer will be standing there telling me that I can't die until I finish filling out my Government death forms and paying my taxes.

As a result of meeting with the attorney for the prenuptial, I told my children the best thing I could do for them was to make sure I left them my house with a big mortgage and outstanding credit card balances and nothing else. If they didn't want to be burdened, I needed to spend all of my money and make sure my companies had relatively little value, because, you see, I made it. I am successful. When I die, I will leave an estate that is probably going to be more money than my father may have made in his lifetime, and we grew up poor—at least, when I grew up, I found out as a kid I was a poor; I didn't know it then. We live in a five-story walk-up tenement in Manhattan.

I have been in the health care business for over 40 years. I believe I do good work helping the people in my community. I pay my taxes, both personal and corporately, maybe not with a smile, but I certainly understand that this country that gave my grandparents and the succeeding generations a chance needs to tax its citizens to continue to be in this country. My oldest son is my partner, and I have a really hard time with the thought that he might have to sell my life work achievements in order to pay the estate taxes that will be due.

NAWBO's position is to repeal the estate tax in its entirety. The so-called death tax creates a disincentive to expand business, create jobs, and often, literally, taxes the family business right out of the family. Many businesses would add more jobs over the coming years if the death taxes were eliminated.

We know that that is probably not the best thing to say at the moment "eliminated," however, we have some suggestions. Increase the exemption to $760,000 and index it to allow it to increase and pass on to the families. Surely, we can get the $1 million exemption level down before the year 2006. Tax trusts on their taxable income at the same rate bracket as for a single individual. Make retirement plan assets up to $1.5 million per person exempt from the estate tax since all such amounts are also subject to income tax, and reinstate the $1 million exemption per descendant for generation-skipping taxes.

I appreciate the Committee considering these issues and the suggestions I have offered. Please know that the leadership of NAWBO and its members look forward to hearing from you and working with you. NAWBO will assist your efforts in any way that we can.

Thank you very much for your time.

[Ms. Kaplan's statement may be found in the appendix.]

Chairman LoBIONDO. Thank you.

I will continue to yield to my colleague from Long Island.

Mrs. McCARTHY. Thank you. My next witness is Steve Breitstone. Now, in defense—because all of you have talked about lawyers, which I kind of think is unfair. You have got to remember the lawyers are only interpreting and trying to work out what we, the Federal Government have put the burden on. So, I don't think it is fair to blame the lawyers; I think it is fair to blame the Federal Government. And I think if you really think that through, you will see that is true.

Mr. Breitstone is a highly respected estate tax attorney from Mineola, my hometown, and has first-hand knowledge of the impacts of estate tax as on small businesses.

Steve, thank you for coming; I appreciate it.

STATEMENT OF STEPHEN M. BREITSTONE, LAW OFFICES OF MELTZER, LIBBE, GOLDSTEIN & SCHLISSEL, MINEOLA, NY

Mr. BREITSTONE. Thank you, Congresswoman. I have been practicing tax law, generally, since 1982. I survived—originally, I was a corporate tax attorney. I survived the Tax Reform Act of 1986. At that time, we were concerned that we were going to be out of work. After listening to today's testimony, I feel like an endangered species— [Laughter.]—once again, but the fact of the matter is that I have confidence in my resourcefulness and my ability to continue, even if the estate tax is repealed, to provide my clients with services that they really need, and I certainly agree with your comment—we do not, as attorneys create the problem. I take great pride in helping my clients who are mainly small businesses to avoid the problem and to manage the problem, and I also find it, I guess, offensive that the rhetoric from Washington continues to be "Let us close all the loopholes; there are abuses." Anything that we can do to help to ameliorate the estate tax to make it manageable is viewed as an abuse, and there have been proposals from the administration time and time again to close these so-called loopholes, and I think that the prospect of doing so is extremely dangerous unless it is accompanied by significant reform, and by reform, I mean raising the levels—the threshold levels before the tax is imposed significantly.

The idea that was talked about earlier of a $9 million threshold that was originally enacted, that is a number, but it doesn't necessarily stand on its own, but it is a much greater number than the current $650,000 exemption. Yes, the tax is deferred, generally, until the second spouse dies if there are two spouses, and you can avoid a total of $1.2 million. The ability to—and this is being increased—the small business exemption enacted in 1997 is a total boondoggle. It very rarely applies, and even it does apply, there are numerous disqualification events that can end up preventing the heirs from being able to conduct the business in a rational, economic manner.

Our practice, as I said, relates primarily to small businesses and closely-held businesses, and by small, I don't mean candy stores; I mean businesses that are owned by individuals starting from start-up companies to the successful family business that has been passed down one, two, three generations in some instances, rare instances. These businesses are inherently perilous.

The people that found these businesses and choose to go into them, really, to me, represent the epitome of the American dream. It is their willingness to give up the safety net and to take the risks that they take personally and financially to start a small business and to run it. Typically, they are undercompensated for their efforts for many years; they suffer from numerous vicissitudes of the marketplace; they are inherently at a competitive disadvantage to large, established businesses; they don't have the ability to raise capital; their stock is illiquid; unless they eventually go to the public markets, their ability to borrow is extremely limited, and it is really ironic, and it is really abominable that at the time that these companies are suffering the major transitional event in their lifetime, the time when they need to pass on leadership from one generation to the next, that they must go out and incur debt or sell off assets to raise capital equal to 55 percent or more of their net worth.

Now, under the best of circumstances, a small business cannot afford to incur that kind of indebtedness or to raise that type of capital without significantly increasing the level of risk associated with the business, and the estate tax—I deal with many companies that are looking to raise capital. We try to help them; that is one of our things we take pride in. But the fact is that raising capital to put into plants and equipment to develop new technologies is something that is attractive to the marketplace. Yes, it is an uphill battle, but if they have something good to offer, they can attract capital. But it is very difficult to attract capital to pay estate taxes, because it is a one-way street—the money goes out and absolutely nothing comes in to pay for it.

I would like to summarize by saying that the thresholds really need to be increased. I am not necessarily in support of a total repeal of the estate tax for the very wealthy, because I do think there are some concentrations of wealth that are anti-competitive as to small business, and I also think that a gradual phase-out of the tax will leave the economy shouldered with the continuing burden of compliance without getting the savings in terms of revenues. So, as the revenues go down, the compliance levels are still going to be very high, and I think that that would be really inefficient.

Thank you.

[Mr. Breitstone's statement may be found in the appendix.]

Chairman LoBiondo. Thank you, Mr. Breitstone.

Congressman Hill, do you have questions?

Mr. Hill. Thank you very much, Mr. Chairman.

First of all, I want to thank you all for testifying, and, Mr. Platt, your testimony could come right out of Montana.

The one point I want to make—and I guess I would ask you about—I suspect if you are like most Montanans, you haven't put a lot of money into a retirement account, and you struggle with a 650–cow/calf operation to feed three families.

Mr. Platt. Ours is a an industry that is capital-intensive and is not a cash cow—no pun intended. I have no savings to speak of. My personal checking account is pretty much a month-to-month sort of thing. Again, the reason that my wealth, if you will, is not liquid in nature—in fact, it is quite the opposite—land is very illiquid and that being the primary element of my estate.

Mr. Hill. I noticed you have some sons you hope to bring in the business. Let me just tell you from personal experience, when I tried to bring sons into my business, one day they realized that the harder they worked to grow the business, the bigger the tax liability they were building for themselves, which is one of the real problems associated with passing these businesses from one to the next.

Ms. Robbins, your testimony I found really interesting, and I would just ask you if you would provide for me some of the foundations of the economic model you did for the projections that you included in your testimony?

Dr. Robbins. Sure.

[The information may be found in the appendix.]

Mr. Hill. I would really appreciate having that information, because I found it really interesting.

Dr. Robbins. Okay.

Mr. Hill. My questions are really for you, Mr.—is it Breitstone?

Mr. Breitstone. Breitstone.

Mr. Hill. Breitstone. By the way, in Montana, the prairie dogs aren't an endangered species; we have a million of them.

Mr. Breitstone. I don't feel so bad. [Laughter.]

Mr. Hill. Right. The situation with a publicly-traded—if you own stock in a publicly-traded company, if you sell that company, that stock—it doesn't have much impact on the value of the company or the ongoing operations of the company. I mean, that is the difference, isn't it, between a privately-traded company or a closely-held company?

Mr. Breitstone. Absolutely. The real impact of the estate tax—the real adverse impact is felt primarily by the small, closely-held business, because, first of all, as an economic unit, even though some are in corporate form, it is very hard to distinguish between the economics of the individual shareholder and the economics of the company; they put their own wealth into the company. But with a public company, public companies have—their shareholdings are widely held; their shares can readily be sold. For the most part, public companies really don't need to be concerned about the estate tax. They don't have to pay for the cost of planning for it and complying with it.

Mr. HILL. And as a matter of fact, I would make the argument that the current tax structure we have, in general, encourages the accumulation of wealth within corporations, publicly-traded corporations, and discourages the accumulation of wealth in privately-held companies, because public companies can hold other companies, and their dividends aren't taxed, and there is all kinds of incentives for the creation of pyramiding of economic wealth in publicly-traded companies.

Mr. BREITSTONE. Many small businesses cash out.

Mr. HILL. That is right.

Mr. BREITSTONE. They sell out to the big companies.

Mr. HILL. One of the things that I found working with small businesses is that more often than not—and you make the point—a lot of these businesses don't succeed in subsequent generations, particularly in the third generation. The percentages are pretty small, and that is because the person that founded the business was the original entrepreneur, and they had the passion for the business and the idea and all that.

One of the problems with these small businesses, when that person dies, that has an adverse impact on the business aside from just the tax impact. I mean, in essence, what we are doing is we are piling on. The entrepreneur dies, and then we are saying "We are going to tax you too. We are going to give you financial penalties on top of all other penalties that you have associated with that." I mean, isn't that part of the problem?

Mr. BREITSTONE. Well, certainly, the death of the entrepreneur is a big hit for a company. I would venture to say that in the ideal business model the types of skills that the entrepreneur was able to muster in order to found the company and just get it off the ground, may not necessarily, in the long run, be the same types of skills necessary for the company to continue as a viable entity into the next generation, and I think that companies grow stronger if they are cognizant of the need to put the proper management in place.

The problem is that management—the qualifications necessary to have management that will be able to carry on, whether it is family or not, is very expensive; it is a significant cost. And I would much rather see that the money go into paying for management and paying for new technologies to be able to stay on top of the market than paying into the tax system, which seems to add very little to the budget.

Mr. HILL. It is nice to hear some of the concerns that you expressed earlier and that is the total elimination of the estate tax, complete elimination of the estate tax. I think the estate tax is unfair. I am concerned about what the impacts of that might be in terms of discouraging people from ever selling anything, because if you pass it from one generation to the next generation without ever incurring any tax liability, we could actually encourage people also, then, never to sell anything.

That is why—I will just ask; you might want to comment on this if you would care to—I have introduced a bill that would eliminate the death tax, but when you die you trigger a capital gains. Your estate would be subject to a capital gains tax. The new basis would be passed on to the new heirs. It sets that tax rate at 15 percent, and, again, you would only be paying a tax on the unrealized gain or you would be recognizing the gain. Savings accounts, retirement accounts—those things wouldn't be subject to that tax.

Mr. BREITSTONE. It is my feeling that the capital gains tax—as we now have it with a very low, effective rate—already serves that purpose. Death is not necessarily the time when a company should be paying a tax. The income tax system does, however, deal with the free market which will eventually dictate whether a company is to be sold, liquidated, whether it is going to continue or not continue, and at the time that the business, the exigencies of the business, which could be many—could be technological changes; it could be supply changes; it could be changes in management; death of an owner; there are just too many to enumerate—but those factors will eventually compel—a business that is insufficient, that gets passed on to the next generation will not succeed and prosper in the long-run unless they are operating it efficiently.

Mr. HILL. And that is the other side of this coin. You specialize in tax avoidance techniques, right? I mean, you help people——

Mr. BREITSTONE. I wouldn't say, necessarily—I certainly wouldn't describe it that way. [Laughter.]

Mr. HILL. All right, I will describe it.

Mr. BREITSTONE. One of the things that I do is manage tax liabilities and structures things in a way that is most efficient from a tax point of view, most efficient from the taxpayer point of view.

Mr. HILL. As you can tell, I am not a lawyer, so I probably didn't couch that exactly the way——

Mr. BREITSTONE. Well, there are many other things that I do than just tax avoidance.

Mr. HILL. My point simply is, is the cost of that, and that costs your customers a lot, doesn't it? I mean, your clients pay a lot, not just in fees to you but accounting fees, evaluation fees, life insurance——

Mr. BREITSTONE. Oh, estate tax planning is an extremely costly endeavor, from legal fees to the cost of insurance. I mean, it compels massive investments in an insurance product which would really make very little economic sense but for the estate taxes.

Mr. HILL. My point, simply, is that is not money invested in the business in growing and expanding it.

Mr. BREITSTONE. Right, exactly; I agree.

Mr. HILL. Thank you, Mr. Chairman. I appreciate the tolerance and the time. Thank you very much.

Chairman LOBIONDO. Thank you. Congresswoman McCarthy.

Mrs. MCCARTHY. Thank you. Number one, I want to thank the whole panel. I think your message has been extremely loud and clear, and there certainly are a number of us here in Congress that will be taking up the fight for all of you at least to try and make it better.

And to Steve, actually, the questions that were just asked were answered by you, and I appreciate that. We thank you for your time, and hopefully we can look forward to certainly picking your brains in the future as we push this thing a little bit further out.

I hope that eventually that we can come to some sort of conclusion on helping our small farmers, our small businesses. As I said earlier, it is the backbone of our country.

So, I appreciate your time and your effort to be here with us, even though—I will explain this—a lot of our members are running back and forth to different Committee hearings and everything else like that and being that today is Thursday, a lot of people are not around, so we never how many—the testimony will get to everybody; they will read it. I thank you.

Chairman LOBIONDO. I just have one question. Roger, you mentioned the situation when you called your mother and asked her if she had had any paperwork saved and what her response was about wanting to get rid of it and just put it out of her mind. Not to sort of open up a raw nerve, but would you suggest that was solely just because of the impact? Did it have something to do with how she was treated by the IRS? Was it a combination of why that experience was so bitter?

Mr. RUSKE. It was a combination of things——

Chairman LOBIONDO. If you could use the microphone, please.

Mr. RUSKE. It was a combination of things. It was a long slow death for my grandfather. Unfortunately, my uncle, who was in the business with him, died a month before he did, so that complicated the whole affair. But my mother is a simple woman. She raised nine children and felt what was yours was yours, and she couldn't understand why these people from Internal Revenue kept badgering them for more money, and it has really turned her off on Government, and every time she sees a bomb being dropped wherever we are dropping bombs now, she says, "Why is my money being used for that? Why did they take my father's money and do that?" So, yes, the Government had a very serious impact on her.

And she—I suppose my attitude towards lawyers come from my mother—but the lawyers and the accountants and the insurancemen are the messenger. I mean, they—Mrs. McCarthy is absolutely correct—they don't do anything; they just tell us what we should be doing.

But it is very personal. Estate taxes have become very personal, and then they become emotional, and then irrational thought comes into it. This is what it unfortunately gets down to.

Chairman LOBIONDO. Okay. Well, I would, too, like to join in thanking all of the panelists. You have helped put a very human face on what is perceived as a problem that is out there somewhere. And often when we deal with issues in legislation, it is helpful to that human face and to hear that human story that you have all done so well to portray to us, and we thank you for taking time out of your busy schedules to be here.

I would like to add that, without objection, we will leave the record open for 10 days for the submission of statements for the record.

And, with that, the meeting is adjourned.

[Whereupon, at 11:54 a.m., the Subcommittees were adjourned.]

APPENDIX

Prepared Statement of Representative Donald Manzullo

I call the Subcommittees to order. Today, we start the inaugural hearing of the Tax Subcommittee on the topic of the estate tax or, as I call it, the "death tax." It gives me great pleasure to co-chair this hearing with my good friend from New Jersey, Frank LoBiondo who was awarded the chairmanship of the Rural Enterprises Subcommittee earlier this year. Congratulations.

I hope that I'm not stealing the thunder from my other colleagues, but there is a saying that there are only two certainties in life – death and taxes. This issue cruelly combines them both.

People should not have to worry about the tax collector standing outside the funeral home door waiting to collect the "death" tax. An estate is built up after a life-time of savings that has already been taxed once!

Plus, with a growing stock market and burgeoning retirement plans, more and more middle-class people will soon be surprised to learn that they are part of the "super-rich." Their heirs will have to pay a substantial "death" tax at confiscatory rates as high as 55 percent.

But today, we are focusing on the devastating impact of the "death" tax on small business. In 1995, the White House Conference on Small Business voted overwhelmingly to place repealing the estate tax as one of the top five priorities for Congress and the President. The Republican Congress did make some reforms towards solving this problem by immediately increasing to $1.3 million the estate tax exemption for family businesses as part of the 1997 tax package.

But more work remains to be done. For many small business owners from where I'm from in northern Illinois, they are "asset rich" but "cash poor." To pay this tax, a business or farm is sometimes liquidated. Many small firms have equipment or inventory well over $1.3 million. Many farmers,
particularly those living in the outer suburbs of Chicago, like McHenry County, own property well over $1.3 million.

Today, we are here to listen to the sponsors of the estate tax repeal legislation that has the greatest chance of passage this year. I am proud to be an early cosponsor of HR 8. We were scheduled to also have Representative Jim Saxton to talk about his landmark study he co-authored in his capacity as Chairman of the Joint Economic Committee but unfortunately, at the last minute, a scheduling conflict prevented him from being here with us today. He did submit written testimony, which is on the table along the side wall. Copies of the entire study are also available there.

In Jim's place, we will hear from an academic expert who can help us put the estate tax issue in perspective. Finally, we will listen to the real-life impact of the "death tax" on small business owners and ranchers throughout the United States. I look forward to the testimony of the witnesses here before us today and I appreciate their willingness to take time out of their busy schedule to travel long-distances to be with us in Washington.

I now yield for an opening statement by my co-chair for today's hearing, Mr. LoBiondo.

FRANK LOBIONDO, NEW JERSEY
CHAIRMAN

DONNA CHRISTIAN-CHRISTENSEN, VIRGIN ISLANDS
RANKING MINORITY MEMBER

Congress of the United States
House of Representatives
106th Congress
Committee on Small Business
Subcommittee on Rural Enterprises,
Business Opportunities, and
Special Small Business Problems
2361 Rayburn House Office Building
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U.S. Rep. Frank A. LoBiondo statement on
Joint Rural Enterprises Subcommittee and Tax, Finance, and Exports Subcommittee
Hearing on H.R. 8, a bill to gradually repeal the death tax
May 13, 1999

I want to thank Chairman Manzullo for agreeing to hold this joint hearing on H.R. 8, a bill to gradually repeal the death tax. I also want to thank our witnesses, Congresswoman Jennifer Dunn and Congressman John Tanner, as well as the many small business owners and tax experts for taking the time to testify today.

No one should have to visit Uncle Sam and the undertaker in the same day. Only with our government are you given a certificate at birth, license at marriage and a bill at death. Death taxes penalize families, punish thrift and discourage entrepreneurship.

By confiscating between 37% and 55%, the death or estate tax places an exorbitant burden on families who try pass on their livelihood to their children. The tax has an especially negative effect on family farms and businesses, as I am sure we will hear today from our witnesses.

Many families spend their entire lifetime building their small businesses. These same families often are forced to sell their business to pay the taxes when they try to pass it on to their children. According to the Center for the Study of Taxation, more than 70% of family businesses and farms do not survive through the second generation. Of those that fail, nine out of 10 successors cited debilitating estate taxes as the reason for their business failures.

Because of the many harmful effects of estate taxes, I am proud to be a cosponsor of H.R. 8 which is sponsored by our two Member witnesses, Representatives Dunn and Tanner. We were able to make some progress on this issue in the tax relief bill last Congress, but more needs to be done. There are many economic motivations to eliminate the estate tax. Economists predict that a repeal of the death tax would create hundreds of thousands of new jobs and billions of dollars of available capital.

The estate tax clearly does more harm than good. I hope we can make significant progress in this Congress to eliminate this unfair tax and allow family businesses and farms to stay in the family.

I will now yield to the ranking member of the Tax, Finance and Exports Subcommittee, Carolyn McCarthy.

Prepared Statement of Representative Carolyn McCarthy

Thank you Mr. Chairman for scheduling a hearing on this important issue. I would like to thank Congresswoman Dunn and Congressman Tanner along with Congressman Saxton for as well as our second panel of guest witnesses for taking time to testify before this subcommittee. We are fortunate to have witnesses testifying on the impacts of the estate tax with such broad and distinguished backgrounds.

I would especially like to thank Steve Brightstone and Arlene Kaplin for acknowledging my invitation and traveling from Long Island to testify before this subcommittee. Their insight and experience with this issue is a welcome addition.

Mr. Brightstone is a highly respected estate tax attorney from Mineola, NY who has first-hand knowledge of the impacts the estate tax has on small businesses.

Ms. Kaplin is a reputable small business owner in the health profession who runs the business with her son in Great Neck, NY. She brings an interesting perspective before this Subcommittee on the impact the estate tax on the healthcare industry.

I thank both of them for taking time out of their busy schedules to be here with us this morning.

As you are all aware, the estate or "death" tax has deviated from its original intent and purpose. From a practical sense, it was established to provide revenue on a short-term basis to finance military action. In theory, however, it was also viewed as a way to protect society against growing concentrations of wealth in the hands of a very few. Supposedly, this tax would encourage entrepreneurship as opposed to "idleness" caused by the inheritance of estates.

Well, entrepreneurship has thrived. Family-owned small businesses have become the backbone of our economy and continue to provide invaluable services. Recognizing their importance, programs have been created to promote their creation and expansion in the form of loans and other assistance programs. Unfortunately, their lifespan is hindered by a disproportionate tax levied when ownership is transferred at the time of death. Less than 30 percent of all family-owned businesses survive through the second generation. This is unacceptable.

The district I represent on Long Island, NY, is dependant on the success of family-owned small businesses. Throughout the Cold War, Long Island became a haven for large defense contractors. The economy was heavily reliant upon the jobs these defense companies provided. However, with the conclusion of the Cold War, Long Island was left to fill a void caused by shrinking defense budgets and numerous layoffs. With the help of various assistance programs, small businesses have filled this void. They have established themselves as an integral part of Long Island's business community.

A lot of hard work and determination is involved to secure a prosperous small business. More often than not the odds are usually stacked against them in the form of a complex tax code or competition by larger companies. The estate tax, however, is a hurdle small businesses must overcome that is more harmful than beneficial.

I thank the Chairman for recognizing the importance of this issue and look forward to hearing testimony from our witnesses on the impact of this tax.

Remarks by Rep. John E. Sweeney
Before the Rural Enterprises Subcommittee
May 13, 1999

Chairman Manzullo and Chairman LoBiondo, thank you for giving me the opportunity to speak about the estate tax and what it means to small business.

The estate tax, commonly known as the death tax, was created for short-term revenue to finance war engagements. It was instated in 1916 at the onset of WWI but was never repealed. Supporters intended the estate tax to discourage inequality between citizens, however it has inadvertently promoted inequality.

The death tax discourages people from saving and investing money. Knowing they and their heirs, in fact, will be taxed after they are deceased, people are finding more ways to circumvent the tax by spending more personal wealth before death or going to great legal expense to utilize existing loopholes.

As you know, my district in upstate New York is one whose economy is driven by small businesses and family farmers. The estate tax is particularly onerous for small businesses and farmers.

The idea of death tax proponents is to redistribute the wealth but it in fact, ends up hurting the people who it is meant to help, working men and women. When farmers sell their land and small businesses close their doors, owners lose their livelihood and loyal employees lose their jobs.

Those of us who understand small business also understand that assets are not an effective indicator of wealth. The death tax is punitive in nature. Upon the death of a parent, many families must take on significant debt in order to pay the tax bill or sell off land and other business assets. It is absurd that families are penalized and businesses put at risk of failure because someone has died.

Those "rich" individuals which are the target of death tax proponents pay almost nothing for estate taxes. Instead they employ lawyers which exploit tax loopholes to entirely avoid paying estate tax. Those left holding the death tax bill are the families who do not have the resources or legal expertise to avoid the tax man.

HR 8, the Death Tax Elimination Act, sponsored by Rep. Dunn and Rep. Tanner is legislation that will phase out the death tax over 10 years. This much needed legislation will provide relief for small business owners and farmers who require our assistance. I am a co-sponsor of HR 8 and I urge everyone to do the same.

Chairmen Manzullo and LoBiondo thank you for the opportunity to speak about this important issue.

JENNIFER DUNN
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The Honorable Jennifer Dunn of Washington
Hearing on the Estate Tax
House Small Business Subcommittee on Tax, Finance, and Exports and Subcommittee on Rural Enterprises, Business Opportunities and Special Business Problems
May 13, 1999

Chairman Manzullo and Chairman LoBiondo:

Thank you so much for holding this hearing to discuss an exciting and popular initiative: repeal of the death tax. I would especially like to thank my colleague on the House Ways and Means Committee, Mr. Tanner, for joining me here today and for being such a strong partner in the fight to end this onerous tax. Over 170 of our House colleagues have joined us in cosponsoring H.R. 8, the Death Tax Elimination Act, which will phase out the death tax by five percentage points each year over the next ten years until the rate reaches zero.

It's been said that only with our government are you given a certificate at birth, a license at marriage, and a bill at death. One of the most compelling aspects of the American dream is to make life better for our children and loved ones. Yet, the current tax treatment of a person's life savings is so onerous that when one dies, the children are often forced to turn over half of their inheritance to the federal government. Even worse, not only does this take place at an agonizing time in the life of a family, but they also have to watch their loved one's legacy be snatched up by an entity not known for its great wisdom for spending money. This is wrong. We should not dishonor the hard work of those who have passed on.

According to a recent study by the Life Insurance Marketing Research Association, less than half of all family businesses survive the death of a founder and only about five percent survive to the third generation. This is terrible public policy, especially in light of the minimal amount of money the death tax brings in for the federal government: just slightly more than 1 percent of all revenues, or $23 billion. In addition, a recent Joint Economic Committee study reported that for every dollar the tax brings in, another dollar is spent by the private sector to simply comply with it. So, the <u>total</u> impact on the private sector is $46 billion.

By confiscating between 37 and 55 percent of a decedent's estate, the government punishes life-long habits of savings, discourages entrepreneurship and capital formation, and penalizes families. This is particularly true because these dollars are often the same ones that have been taxed four and five times - through income tax, capital gains, tax on dividends, etc. Under today's tax system, it is easier and cheaper to sell the business or farm at the 20 percent capital gains rate than try to pass it on to the family after death.

Of course, Congress has attempted to help ease the burden of the death tax by increasing the personal exemption to adjust for the inflation of assets. Unfortunately, this will continue to be too little help as home values, the increasing popularity of defined contribution retirement plans, and the trend toward more small business entrepreneurship drives middle class estates above the exemption. Congress has also tried to help small businesses by creating an additional death tax exemption for family-owned businesses. Here too, however, is where a good idea becomes impractical in the real world. The family-owned business exemption enacted as part of the Taxpayer Relief Act of 1997 creates 14 new definitions with which a business must comply before it is eligible for relief. Although a good idea at the time, this exemption has proven to be nothing more than a boondoggle for attorneys and estate planners.

Recently, I asked an estate tax attorney who advises 200 family-owned businesses how many of those businesses are eligible for this exemption. His answer? 10. No amount of artful drafting will provide relief to only those Congress deems worthy. We must not continue to pat ourselves on the back for legislative triumphs that fail to benefit hard-working Americans. Family relationships and the private sector are far too complex for us to thoroughly duplicate in federal tax law. It is time to be bold.

The Death Tax Elimination Act is the right answer at the right time. The productivity of enterprising Americans and a frugal Congress intent on reducing wasteful spending has helped to produce the first budget surplus in a generation. What will be Congress's response to this surplus? Will it spend the money on dozens of worthy programs that could no doubt be created to help various people? Or, will it cobble together a complicated and voluminous tax initiative that aims to help everybody and, therefore, helps almost no one? I strongly believe that we must provide the American people with a vision.

This vision must center around two main principles: the surplus belongs to the American people and it ought to be returned to them; and we must honor the institutions on which strong communities are built. I can think of no better initiative that so well defines these two principles than repeal of the death tax. The ingredients to a successful family or business – thrift, diligence, and the suspension of gratification – must be once again rewarded, not taxed.

I hope that you will all join Mr. Tanner and I in this worthy fight. Thank you again for providing a forum to discuss this important issue. I look forward to answering any questions you may have.

Testimony
Submitted By
U.S. Rep. John Tanner
Eighth District, Tennessee

Presented
To The

Committee on Small Business'
Subcommittee on Tax, Finance, and Exports &
Subcommittee on Rural Enterprises, Business Opportunities,
and Special Small Business Problems

311 Cannon House Office Building
U.S. House of Representatives

On

The Economic Effects Of The Federal Estate And Gift Tax System
On Small Business And Its Proposed Repeal

May 13, 1999

Good morning. I want to begin this morning by thanking Chairman Manzullo, Chairman Lobiondo, Representative McCarthy, Delegate Christensen, and Members of the Committee on Small Business' Subcommittee on Tax, Finance, and Exports and its Subcommittee on Rural Enterprises, Business Opportunities, and Special Small Business Problems, for holding today's hearing.

We are here to examine the economic effects of our federal estate and gift tax system on small businesses and family farms along with the potential effect of its repeal. You are to be commended for your willingness to focus on this important issue.

When I think of the federal estate tax, I think of Frank Markham, Jr.

I knew Frank's father and I have known Frank for many years. Like so many families in the rich Mississippi Delta floodplain of West Tennessee, Frank and his family operated a family farm just outside Tiptonville, Tennessee.

In the late 1970s, tragedy struck the Markham family though when Frank's father passed away. It wasn't long after that Frank and his family realized they faced an estate tax bill of more than $150,000. That may not sound like a lot of money today, but I can assure you it was a lot of money then. Indeed, many small business owners and family farmers consider that a lot of money today.

An auction was the next step for the Markham family. To pay the estate tax bill, Frank's family was forced to auction off some of their farm equipment. Fortunately, he did not lose the farming operation his father built, but many have solely because of this tax.

What's important about Frank Markham is that he and many like him don't fit the established rhetorical boxes that have traditionally framed the debate about the future of the estate tax. Historically, estate taxes were considered a good way, in the words of President Franklin Roosevelt, to prevent the "perpetuation of great and undesirable concentrations of control in a relatively few individuals over the employment and welfare of many, many others."

It's no longer a rich versus poor issue though. That, in my view, is a myth and here's why. America has changed since the days of FDR. Opportunity and entrepreneurial spirit have led to wealth creation, which transcends such societal and historical barriers as age, race, and sex. I am not offended by the wealthiest among us, the Trumps and the Forbes', paying some tax on the transfer of extraordinary wealth from one generation to another, but more than half of this tax is now paid by average, hard-working Americans.

According to the Internal Revenue Service, 70 percent (69.7%) of America's taxable estates are valued at $5 million or less, yet those estates are responsible for paying 51 percent of the total estate tax paid.

Particularly burdensome on small businesses and family-owned farms, the estate tax stifles entrepreneurial spirit and paralyzes small communities throughout the rural South that rely on them to boost local economies and create jobs.

The over-riding issue for this Congress is whether it believes we should continue to penalize the generational transfer of wealth and property. To continue that, I believe, is just plain wrong, particularly when it comes to small businesses and family farms.

Consider: 70 percent of America's family-owned businesses don't survive to a second generation, and 87 percent don't survive to a third generation. So it should be no surprise to your Subcommittees, or anyone else for that matter, that the 1995 White House Conference on Small Business made the repeal of the federal estate tax one of its top priorities.

The estate tax was created in 1916 to help finance America's role in World War I. In recent years, we have successfully increased the exemption, but the increased exemptions established in the Taxpayer Relief Act of 1997 are no longer keeping pace with inflation. The current estate tax exemption is $1.3 million for small businesses and family-owned farms.

Today, estate tax rates are set at 37 percent and 55 percent depending on the size of the estate and that is just to onerous.

By mid-July the House Ways and Means Committee will put together a tax relief measure that meets the Committee's obligations under the fiscal year 2000 budget resolution. In the weeks ahead we will be working to craft a tax bill that provides for up to $778 billion in tax relief over 10 years.

It is my hope that working with Representative Dunn and others we can succeed in providing for a reasonable estate tax rate reduction in that bill. Rate reduction is the only way we will truly will be able to provide relief to small businesses and family-owned farms, while reducing the disincentives to the generational transfer of property that exist today in the form of the federal estate tax.

Finally, I want to close with a little common sense. This is how Mike Brundige of Martin, Tennessee, put it in a letter published in The Union City Daily Messenger, "Rep. Tanner is right to stick up for working people who save their money to build businesses and want to pass them along to their family members.

"It is one of the most important things we can do to ensure that the ownership of farms and small businesses here in West Tennessee remain in the hands of the families that built them."

I want to thank Chairmen Manzullo and Lobiondo, Representative McCarthy, Delegate Christensen, and the Members of these two Subcommittees for focusing attention on an issue that is vital to America's small businesses and family-owned farms.

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"How Estate Taxes Affect the Economy and Small Business"

Testimony of
Aldona Robbins

Presented at a Hearing of the
Committee on Small Business of the U.S. House of Representatives
Subcommittee on Tax, Finance and Exports
and the
Subcommittee on Rural Enterprises, Business Opportunities,
and Special Small Business Problems

Washington, DC
May 13, 1999

Mr. Chairman and members of the Committee, I am Aldona Robbins, Vice President of Fiscal Associates and Bradley Senior Research Fellow at the Institute for Policy Innovation (IPI). Also with me is Gary Robbins, President of Fiscal Associates and Olin Senior Research Fellow at IPI. We thank you for the invitation to appear at this hearing on the economic effects of estate taxes. My remarks summarize our findings in an IPI study entitled "The Case for Burying the Estate Tax."

Until recently estate taxes were the almost exclusive headache of the super rich, their tax attorneys and their estate planners. But, a strong economy, an ever-widening distribution of wealth – both good things – coupled with short-sighted tax policy are extending the reach of estate taxes well into middle class America.

Estate taxes in the United States date back to the Stamp Act of 1797 which was used to finance the 1794 undeclared naval war with France. The tax was repealed in 1802. That set a pattern for the next hundred years or so. That is, estate taxes were used as a sporadic, and temporary, way to finance wars – the Civil War, the Spanish-American War. When hostilities ceased, the tax was repealed.

In the early 20th century, worldwide conflict cuts into trade tariffs – a mainstay of federal revenues – and Congress turned to another revenue source. The Revenue Act of 1916, which introduced the modern day income tax, also contained an estate tax with many features of today's system. After an exemption of $50,000 (almost $9 million in terms of today's wealth), tax rates started at 1% and climbed to 10% on estates over $5 million. Estate taxes were increased in 1917 as the U.S. entered World War I.

However, unlike before, this time the estate tax did not go away after the war ended. Despite sizable budget surpluses, Congress hiked rates and introduced a gift tax in 1924. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. During the 1920s through the 1940s, estate taxes became another weapon in the arsenal to redistribute income. Tax rates of up to 77 percent on the largest estates were supposed to prevent wealth becoming increasingly concentrated in the hands of a few.

Now let's fast forward to the late 1960s and early 1970s when loophole closing preoccupied tax reformers. Their efforts culminated in a 1976 tax bill that overhauled estate taxation, giving us the system we still have today. Perhaps the biggest change was combining the previously-separate exemptions for estate and gift taxes and transforming it into a single, unified estate and gift tax credit.

The 1981 tax bill brought some relief. Rates were cut – the top rate went from 70 to 50 percent, and an increase in the unified credit took a lot of smaller estates – those under $600,000 – off the tax rolls. But, after that, the search for revenue to fight budget deficits led to more than a decade of bills that largely increased estate taxes.

In 1997, Congress provided some relief with the first increase in the unified credit since 1987. Beginning in 1999, the unified credit is set to increase gradually. By 2006, estates under $1 million should not be taxed.

Where are we today? Today estate taxes are more likely to affect small to medium-sized estates than fifty years ago. In 1945, estates under $2.5 million (in today's asset values) accounted for about a third of all returns. In 1995, those estates accounted for 89 percent of returns.

Why do increasing numbers of middle income Americans face the prospect of having their heirs presented with an estate tax bill? Mainly because time has seriously eroded the value of the estate tax exemption. As I have said, the value of the exemption in today's wealth has dropped from $9 in 1916 to the $650,000. With Wall Street's spectacular performance of the last several years, it is easy to see how a middle class family who owns a home and has IRAs, 401 (k)s or other retirement accounts could hit $650,000 fairly easily.

And, if an estate exceeds $600,000, it is taxed at a rate starting at 37%. Tax rates rise, reaching the top rate of 55% after $3 million.

What about macroeconomic effects? About half of all saving is directed toward bequests. But high marginal estate tax rates discourage saving which, in turn, leads to less investment, slower economic growth and lower tax revenues.

What's more, the sheer complexity of estate taxes results in high compliance costs – as much as estate taxes raise by some estimates. Compliance adds nothing to economic output while diverting resources from better uses.

We estimate that eliminating the federal estate tax would:

- Increase GDP by almost $1 trillion over the next 10 years;
- Increase the stock of U.S. capital by almost $1.7 trillion and
- Create almost 275,000 more jobs.

Reducing estate taxes would generate sizable economic gains with little real revenue loss. Over the next ten years, doing away with the estate tax would produce $3.67 in output for every dollar of static revenue loss. Longer run, the ratio of GDP gain to static revenue loss would rise to $5.18.

Why does the death tax do so much harm to the economy relative to the revenue raised? Government can set the amount of the tax based on the asset value – as it does with estate taxes or property taxes – but the simple fact is that the tax must be paid out income produced by the assets. Let me repeat, all taxes are paid out of income.

Let's look at two small business examples. Take a family-run store which yields a 10 percent return, after inflation, each year. Taxes reduce the return to 5 percent.[1] If the owner dies and is subject to the 55 percent death tax rate, how do the heirs pay the bill? Do they send 55 percent of the store's inventory or other physical assets to Washington? No, Treasury doesn't accept payment-in-kind, only cash. If the heirs devote the entire 5 percent annual return, the death tax could be paid off in only 11 years. Unfortunately for the heirs, Treasury wants the

[1] A tax rate of 50 percent might seem high, but we calculate the economy-wide, marginal tax rate on private business capital at roughly 67 percent.

money now. They could borrow from the bank at 9 percent (4.5 percent after tax) and pay off the loan in 50 years. But, would the heirs want to run the store for 50 years for free? Probably not. They would sell the store.

This example may seem extreme, but it is not as outlandish as one might think. Consider the small farmer who owns land near an urban area. His farm would yield a 10 percent return only when it is valued as farm land. But, tax law requires that the asset be valued at its "best use," lowering the pretax return to 5 percent (2.5 percent aftertax). In this case, even the 50-year bank loan won't save the farm.

The lesson to be learned here is that all taxes are paid out of income. Even if the death tax is a "rare" event, only one chance in a lifetime, its average impact is very large – large enough that for some the combined effects of income and death taxes approach 100 percent.[2] In cases like these, the message is "don't invest, consume."

The Congress has tried to address the hardship circumstances for farmers and small business in general. But, the remedy effectively has the government standing in for the bank. The final result is the same – heirs are left with a choice of owning a nonperforming asset for a number of years or simply selling. What is more, the IRS has taken these half measures as an excuse to raise appraised estate values, thereby reducing the tax relief.

The investment decision becomes even more complicated if there are ways to organize holdings to pass the income stream to heirs. Tax planning can significantly mitigate the effect of the death tax. Because amounts involved tend to be large, estate planning richly rewards taxpayers who can anticipate that they might be subject to the tax. Those that don't plan or can't anticipate are caught and pay the tax.

That's one reason why the largest estates do not pay the highest tax rates. Who does? Typically they are owners of small businesses, family farms and savers who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax.

[2] The impact of a tax imposed on assets must be multiplied by one divided by the aftertax rate of return. Thus, the impact of the estate tax is magnified by 10 for an asset with an aftertax return of 10% and by 20 for an asset with a 5% return.

In short, the estate tax is one of the most inefficient and wasteful features of the current tax system. Serious reduction or outright elimination of estate taxes might be one of the best legacies that the 106th Congress could leave future generations.

Statement of the American Farm Bureau Federation

TO THE
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS
HOUSE SMALL BUSINESS COMMITTEE
REGARDING
THE DEATH TAX ELIMINATION ACT, H.R. 8

Presented by

H. Jay Platt
Arizona Farm Bureau Federation
Board of Directors

May 13, 1999

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As the national voice of agriculture, AFBF's mission is to work cooperatively with the member state Farm Bureaus to promote the image, political influence, quality of life and profitability of the nation's farm and ranch families.

FARM BUREAU represents more than 4,800,000 member families in 50 states and Puerto Rico with organizations in approximately 2,800 counties.

FARM BUREAU is an independent, non-governmental, voluntary organization of families united for the purpose of analyzing their problems and formulating action to achieve educational improvement, economic opportunity and social advancement and, thereby, to promote the national well-being.

FARM BUREAU is local, county, state, national and international in its scope and influence and works with both major political parties to achieve the policy objectives outlined by its members.

FARM BUREAU is people in action. Its activities are based on policies decided by voting delegates at the county, state and national levels. The American Farm Bureau Federation policies are decided each year by voting delegates at an annual meeting in January.

STATEMENT OF
THE AMERICAN FARM BUREAU FEDERATION
TO THE
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS
HOUSE SMALL BUSINESS COMMITTEE
REGARDING
THE DEATH TAX ELIMINATION ACT, H.R. 8

Presented by

H. Jay Platt
Arizona Farm Bureau Federation
Board of Directors

May 13, 1999

My name is H. Jay Platt. My statement today is made on behalf of the American Farm Bureau Federation, an organization of farmers and ranchers whose membership totals 4.8 million families who produce all commodities commercially grown in this country. I sit on the Board of Directors of the Arizona Farm Bureau Federation and serve as President of my county Farm Bureau in Apache County, Arizona.

Thank you Chairman Manzullo and members of the Small Business Subcommittee on Tax, Finance, and Exports, for holding this hearing on death taxes. I've traveled to today's hearing from St. Johns, Arizona, where I operate a cattle ranch with my wife, Tricia and my two younger brothers. My brothers and I are the third generation to graze cattle on the ranch that was started by my grandfather early this century. My sons plan to become fourth generation ranchers if my family and I are not put out of business by death taxes.

Ranching is my second career. I returned to my family's ranch after six years as a big city attorney because I value the lifestyle, like the independence that comes with ranching and wanted my children to have the work opportunities that are unique to a family ranch. Our operation involves two tracts of land, one in Arizona and one in New Mexico, that total 125,000 acres. We own about 20,000 of those acres and rent the rest from state and federal governments. Our cattle herd is made up of 650 mother cows plus their calves, reduced from our normal 1,000 cows because of drought. This may sound like a lot of land to some people, but we are a typical operation for our part of the country where 100 acres are needed to support a single cow.

My hometown of St. Johns, population 3,500, is halfway between Phoenix and Albuquerque. In an area of the state with few roads and few people, agriculture is the foundation of our community and our local economy. Ranchers keep the local hardware store, the single grocery store, and our three gas stations in business. My ranch neighbors serve on school boards and volunteer in churches. If Apache County ranches can't survive death taxes, the character of northeastern Arizona will be changed forever.

The loss of Apache County ranches like mine will also damage the environment. Even though my ranch is far from the urban pressures that turn open space into strip malls, the forced sale of my ranch due to death taxes will not likely be to another rancher. Rather, the property will be broken into 40-acre "rural ranchettes," and sold to absentee owners as lots for second homes. My family and I work hard to take care of our land because it is the basis of our livelihood. Building houses on our property will not only damage fragile rangeland but shift ownership to people who are more interested in recreation than conservation.

I am 48 years old and am beginning to plan for my death. This is not easy for my family even though I know from settling my parent's estate that estate planning is important. Estate tax law is complex and planning requires the advice of experts. I drive 440 miles round-trip and spend the night in Phoenix every time I need to meet with my attorney. This costs money my family needs to keep up our ranch and cover living expenses and the time away from home reduces the time I have to manage my ranch. But I go through the trouble for a good reason. I know for certain that that if I don't plan, my family will be forced to sell large parts of our ranch to pay death taxes.

My grandfather started our ranch around the turn of the century with a couple of cows on a few acres of grazing land. For 100 years, my family has worked hard to build our operation into a modern ranch that that is the core financial base for three families. We paid taxes on everything we've earned and we don't understand why we have to pay again when we die. We can't comprehend why the government wants to penalize us for being successful by taking our ranch at death. We believe that our family, our community and the environment will all be better off if our ranch continues.

Members of the American Farm Bureau Federation share this view from coast to coast. Farm Bureau supports an immediate end to death taxes. In fact, death tax elimination is Farm Bureau's top tax priority. Farm Bureau is actively working for passage of H.R 8, legislation to eliminate death taxes by reducing rates 5 percent a year until the tax is gone. I urge each of you to join in the effort to eliminate death taxes.

Thank you for the opportunity to make this statement. I welcome your questions.

H. JAY PLATT
BOARD OF DIRECTORS
ARIZONA FARM BUREAU FEDERATION

H. Jay Platt, a member of the Arizona Farm Bureau Federation Board of Directors, resides in St. Johns, Arizona. The town, with a population of 3,500, is located between Phoenix and Albuquerque.

Platt and his brothers are third generation ranchers and graze cattle on 125,000 acres located on two tracts of land in Arizona and New Mexico. They own 20,000 of those acres and rent the rest from the state and federal governments.

Platt, 48, is an attorney and practiced law for six years before returning to the family ranch. He serves as president of the Apache County, Arizona, Farm Bureau. He and his wife, Tricia, have five children, two of whom still live at home.

Pursuant to Rule XI (2)(g)(4) of the U.S. House of Representatives in the 105th Congress, neither the American Farm Bureau Federation, the Arizona Farm Bureau Federation, nor H. Jay Platt receive any federal grants or contracts.

TESTIMONY ON FEDERAL ESTATE TAXES

I am a third generation nurseryman following in my grandfather's footsteps, my son, Chris, is the fourth generation of our family in this business. Agriculture is a very difficult profession at best. Daily, we must deal with the capriciousness of *Mother Nature*, unending government rules and regulations, marketing our product and the normal problem solving of any business.

In my business, if one is to be successful, planning for the future is essential. The crop we plant today will not be harvested for one (1) to five (5) years, therefore, very careful preparation and long-range planning for growing and marketing is paramount to our survival. We understand long-range planning!

My grandfather began his nursery business in Connecticut in the early part of this century. He was a *"natural"* farmer and an exceptionally hard worker. In our town, he was known as the "midnight farmer" because he worked at one job during the day and built up his own business working well into the night.

Grandpa persevered through the Depression, World War, barn fires and Japanese Beetles to become a very successful and well-known nurseryman. He also believed that what he earned and saved, after paying income taxes, was his to do with as he pleased. He thought he would be able to leave to his family his accumulated wealth and possessions without any interference from government or anyone else.

Late in life he was convinced by his family that estate planning was necessary in order to preserve his estate. Unfortunately, he chose the wrong financial advisors and when he passed away the family was left with quite a problem *- that problem was Federal Estate Taxes*.

It took years to settle the estate and for the family to realize any financial gain, it was necessary to sell the property and business. During all this time, the IRS was a constant thorn in the side to the family, demanding even more paperwork, documentation, and money. Some five (5) years after he died and the estate was settled, IRS was still sending letters and looking for more money.

While some of this situation was the result of poor planning on my grandfathers part, he should never have had to go through this experience. It is wrong for the Federal Government to tax a person's income while they are living and then again tax it a second time when they die.

In preparation for this testimony, I asked my mother about grandpa's estate and if the papers were still available. She told me that as soon as the required time for keeping the paperwork had expired she destroyed everything. She did not want to be reminded of the hell her own government put her family through.

Once again, a successful family business was destroyed by the Estate Tax -- not to mention the stress and strain on the remaining family members.

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Testimony on federal Estate Taxes
Roger Ruske

Let's fast forward to the third and fourth generation:

My wife, son and I have a 275-acre nursery in Cumberland County, New Jersey. I believe that by most standards we are successful. I want to leave the business and my assets to my wife and son intact so that the business can continue. In order to prevent my Federal Government from confiscating a large portion of my estate, I have a Will that consists of many pages, setting up trusts of all kinds and a myriad of other financial plans to enable my family to keep our business and the assets to run it. This has been quite a financial burden on my business family not to mention the additional stress it adds to everyday living.

I should not have to expend valuable time and assets to protect my business and family from the Federal Estate Tax. My earnings and capital gains are taxed during my lifetime – once is enough! If there was ever an unfair or arbitrary and capricious law the Federal Estate Tax is it. People who work hard and are successful are penalized, people who conserve their assets are penalized and in many cases entire families and their businesses are ruined by this insidious incursion into our lives.

The answer to this problem – ***abolish the tax now.***

The government's reply to this is that it would cause a budget shortfall. My answer .... pretend you were hit by a hailstorm, drought, severe flood, cold winter or declining prices! This is what happens in the real world of agriculture. If we have a budget shortfall, we have to adjust our lives and businesses accordingly I suggest that my government do the same

Thank you for the opportunity to express my views on Estate Tax.

Dated: *May 13, 1999* *Submitted by:* *Roger J. Ruske*

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Sixtieth Anniversary
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Testimony of Kevin O'Shea

Chief Financial Officer
Shamrock Electric Co., Inc
Elk Grove, Illinois

On Behalf of
National Small Business United

The Impact of the Estate and Gift Tax on Small Business

Before the Tax, Finance and Exports Subcommittee and the Rural Enterprises, Business Opportunities and Special Small Business Problems Subcommittee

May 13, 1999

Mr. Chairmen, Ranking Members, Members of the Subcommittees, thank you for allowing me to appear before you. My name is Kevin O'Shea, Chief Financial Officer of Shamrock Electric Company Incorporated of Elk Grove, Illinois. I am also a member of National Small Business United (NSBU), the oldest small business organization in the nation representing 65,000 small businesses in all 50 states.

As members of the House Small Business Committee, I know you are well aware of the impact that the estate and gift tax -- also known as the death tax -- has on America's 23.3 million small business owners. For you to take the time to address the shape and scope of reform on the death tax is critical and I applaud your efforts.

For years, families, like mine, have been faced with the problem of liquidating the family business in order to pay for the taxes on its inheritance or to drain valuable resources from the business to establish costly and confusing trusts. <u>Congress should repeal the death tax</u>.

The Shamrock Electric Story

I have changed the old saying from "the only certain things in life are death and taxes" to "the only certain things in life are death, taxes and paying taxes after your death."

My grandfather started our family business in the 1910's. In the 1950's my father and uncle took over the firm. The business was not really worth anything at that time, but through hard work and determination, they turned it into a very successful company. When my uncle passed away, my father received his stock through a buy-sell agreement. My father is now 68 years old, and he wants to start slowing down. He has a winter home in Florida where he goes for 5 months each year.

Today, our company has about 10 families that have more than one relative working for us. I consider us to be the essence of a family owned business. My father and I put a high priority on our employees and their future with our company. We sell construction services, and we are nothing without our employees. We have spent the last eight years planning so that their future would not be jeopardized. We have spent over $400,000 on estate planning in that period of time, and we will continue to spend an amount equivalent to 10% of our firms after tax profits on estate planning. This is money that could be used to expand the company, could be used to pay our employees more, or could be used in a hundred different ways to make our company a better place to work. Instead, we use the money to plan for the eventual death of my father, so we can give a cash equivalent to half of his life's work to Estate Taxes.

When my father does leave, I will own the company and the estate taxes will be paid through life insurance, planning, and luck. Here are my complaints about the whole process:

1) For the past eight years, when my Father and I would discuss estate planning, all of my sentences would start with "when you're gone". I don't like to think about my father's inevitable passing. It has left lasting emotional scars on both my father and I to go through this process. If the death tax were buried, future generations would be sparred this problem.

2) When we first started discussing estate planning, my father was going through some health problems. It was very difficult for me to deal with estate planning while my father was staring his own mortality in the face. I can't imagine what he went through.

3) In the first few years of our estate planning, the company, and our industry as a whole was having a down cycle. We had a few years that we almost lost the entire company. But through it all, we had to pay the attorneys, accountants and life insurance companies to keep the plan going, in the event that there would be a company left to pass from one generation to another. We would have pulled out of the tailspin sooner if we did not have the huge overhead cost of estate planning.

4) The process of estate planning has caused a rift between my only other sibling and I. Because I am involved with the company, the plan is that I get the company and my sister gets an equal value of cash and other assets when we settle the estate. Because of the tax planning however, my father's will reads that she will get an amount equal to what the company was worth when we transferred it to me. I have received my inheritance from my parents, even though they are still around. My sister will not receive hers until they are both gone. My inheritance is growing in value; hers is a set value when the estate is settled. She was my "best person" at my wedding-we've been best friends all of our lives - The process of planning for the continuity of the business has caused animosity between us. I hate that.

The relationships I have with my father and sister are more important to me than the company. But, remember there are 120 families that depend on this company for their weekly paycheck. We are forced by the government to go through this process of estate planning so that those families have a future.

And, it isn't just Shamrock Electric Company who faces this problem day in and day out. I was an elected representative to the White House Conference on Small Business in 1995. Repeal of the Death Tax was one of the top three topics from that conference. That's 2,000 small business owners speaking in unison: Please repeal the Death Tax.

Death Taxes: Who pays, the truth vs. imagination

The traditional rationale for estate taxes is fairly simple: taxing unearned, windfall income at high rates does not hurt the economy and can provide needed streams of revenue to federal coffers. But when looked at more closely, we find that these presumptions do not hold up.

First, there is a widespread and preconceived--but wholly inaccurate--notion of exactly whom estate taxes are likely to affect. Many architects of our current tax code seem to believe that those who pay estate taxes are exclusively leisure-class individuals who have inherited vast amounts of wealth and property and streams of income they have not toiled a day to earn. But the fact is we already do levy taxes on these people--for the very wealthy, estate taxes run 55-60 percent of the entire inheritance. And such individuals can shelter vast amounts of wealth in trusts that can provide a secure income stream to their heirs. So, the net effect of our estate tax system is not so much the taxation of unearned wealth, but the devastation of many small family businesses.

Suggestions that those who pay estate taxes are rich is misleading at best, and as you will tell from my family's story, wholly inaccurate. Many small business owners work a lifetime to build a growing and successful business, plowing profits and capital back into the business. The value of that business at the time of a transfer may seem substantial, but it often supports a very middle class family that does not have the extraordinary resources necessary to pay estate taxes. Policy makers have justified highly confiscatory estate tax rates, since they (it is said) deprive heirs only of money they have not "earned." This type of thinking is very alarming to the thousands of family members who have labored a lifetime in their parents' businesses--in order to help build a firm which they might someday pass to their own children, only to have the government proclaim that they have not "earned" it.

On a personal note, I started at Shamrock when I was 14 years old, working in the warehouse during the summer. I have held ever job at the company from truck driver to electrical apprentice and draftsman to Chief Financial Officer; to be honest I have prepared myself to be a part of Shamrock from my very first day of High School. I work 40 hours during the slow times and 60 hours during our peak times. To have someone say I have not "earned" the value of Shamrock Electric is very insulting to say the least.

I also want to remind members of the panel that every dollar of value that resides in most small business owner's personal estate and assets owned by their companies have been acquired with after-tax dollars. When the company is profitable, they pay income taxes to every level of government, from the local municipality in which they live or work, to the state and federal governments. In years in which the company is not profitable, it is still taxed. They pay real estate taxes and personal property taxes on the productive assets used in the business. They also pay unemployment taxes, workers' compensation taxes, and the payroll taxes that go to support Social Security and Medicare. Quite frankly, I find the notion of death annoying enough on its own; the fact that government is going to make one last grab at small business owner's assets when they are no longer here to defend them is adding insult to injury.

Liquid assets and Small Business

In many ways, liquidity is at the heart of the estate tax debate for many family businesses. One of the biggest on-going problems for small businesses is providing sufficient cash flow for the day-to-day operation of the business. So, when a large estate tax bill arrives, many families are forced to sell the business to pay the taxes. Even with the current exemption - and even the small business specific $1.3 million exemption – many small businesses simply do not have the liquid assets to pay their tax bill.

Also implicit in estate tax proposals is the suggestion that high estate taxes do not hurt the economy because it is a tax on "windfall income" and therefore not subject to "higher taxes hurt productivity" allegations. Windfall income? Such proponents seem to have no concept of the difference between frozen and liquid assets. A frozen asset in the form of a business would have to be sold in order to pay the taxes. Some businesses are even forced to sell piecemeal: the land, the building, the equipment, the supplies, all go to different buyers, and the business is closed. The business stops paying taxes and its employees lose their jobs. This scenario hardly represents a prescription for painless increased federal revenues.

I mentioned earlier that we are nothing without our employees. Our employees have a very strong loyalty to this firm. If we were forced to sell Shamrock to pay the tax bill, the employees would leave and there would be no value to the new owner. Fellow members of the construction industry are aware of this and it is very common in my field. This actuality makes it exceedingly difficult to sell a firm after a founder's passing, which is an unforeseen and often unmentioned issue caused by the death taxes existence.

Capital Formation

Though estate taxes are often seen as a fairness issue for small business owners, estate taxes also represent a tremendous ongoing capital drain on family businesses. For a family business to face up to the many challenges posed by the estate tax and survive -- intact -- is a formidable chore. Effective estate planning is a drain on the resources of the business. Assets diverted, whether to an insurance policy or another device, to pay an eventual tax is money, which cannot be invested in the business to grow and create jobs. In this sense, the estate tax is a daily drain on a family business years before such a tax is ever actually owed. When a business owner has had the foresight to plan for a smooth transition, it might appear that the estate tax has had little effect on the survivability of the business. But such a business may have already been hit by the estate tax, again and again over the years, as opportunities for growth and investment were passed up, in order to channel funds for estate planning. These funds are better spent on productive assets that would create jobs and strengthen the company. The system, which perpetuates this situation, is very shortsighted.

To sum it all up, I will add a quote attributed to Albert Einstein: "Not Every Thing That Counts Can Be Counted; And Not Everything That Can Be Counted Counts". I would like to thank the Members of the Tax, Finance and Exports Subcommittee and the Rural Enterprises, Business Opportunities and Special Small Business Problems Subcommittee, especially Chairman Manzullo and LoBiondo and Ms. McCarthy and Ms. Christian-Christensen for allowing me to appear before you today. Please help my family and millions of other working families by repealing the death tax. Don't make my children suffer through what I have had to. Please bury the death tax.

STATEMENT OF ARLENE KAPLAN

Good morning, Mr. Chairman and members of the Committee. Thank you for the opportunity to appear before you today to discuss the issue of Estate Taxes and its impact on women owned businesses.

My name is Arlene Kaplan and I am the CEO and Founder of:
Heart to Home Inc., Heartland on the Bay and WORKPLACE CPR. in New York on Long Island.

I am on the Board of Directors of the National Association of Women Business Owners.

I am not a tax expert, unless I qualify because I pay lots of taxes-personal income tax, corporate income tax and employment taxes.

I am here before you to ask if I've already paid tax on everything I own while I'm alive, why do I have to pay taxes on these same things when I'm dead?

I do not mean to be flip since the topic is very serious, I'm just expressing my frustration with a tax situation that seems to have gone awry.

The Estate or "Death" (as it has become known) Tax was initiated in 1916 to fund World War 1. It was maintained in the tax code through the 20's and 30's to help prevent the concentration of wealth. Since that time, anti-trust laws have eliminated those concerns, but to date, the Estate Tax remains intact.

I'd like to go back before World War I to before the turn of the century so that you know a little better who I am. And I'm sure there are millions more like me. three of four of my grandparents came to America before 1900 and one came just after.

They all came from the area known as the Pale, the area between Russia an Poland.

Their children were born here and all of them got at least a high school education. Two of the children even went to college.

Coalition groups have been advocating estate tax reform for several years. They have described the estate transfer tax as a penalty tax on small, family-owned businesses, costing the government almost as much to administer as the revenues it generates. It costs approximately 65 cents for every $1.00 of revenue collected for the collection and compliance of the estate tax. While wealthy taxpayers have the ability to hire tax attorneys to avoid the estate tax, many small businesses must be sold by family heirs to raise funds for the estate tax. Business assets are liquidated to pay taxes rather than passed on to children who in many cases would continue to operate the business.

Small family-owned businesses account for over half of the U.S. gross national product and a majority of wages paid. Many heirs of these businesses are subjected to estate tax rates of 55% and higher, and must use earnings of the business or liquidation of the business to cover the tax bill.

Women business owners account for over 8.5 million businesses in the United States generating over 3.1 Trillion dollars in revenue. We would like to be able to pass our business on to our children and/or our grandchildren and not burden them with having to raise large amounts of capital to hold onto our life's work.

In 1995 White House Conference on Small Business listed repeal of the estate tax as an issue of serious concern to small business owners nationwide. Operating as an excise tax on accumulated assets, which have already been taxed once as income, the estate tax is viewed by many as just another government way of confiscating wealth and redistributing it. It has been described as a massive transfer of wealth from families direct to the U.S. Treasury, and as such, encouraging citizens to spend and consume rather than save and invest.

It's been said that only with the U.S. government are you given a "certificate at birth, a license at marriage and a bill at death."

Many Americans work hard all of their life building a family business–paying their fair share of taxes along the way–to save and invest for retirement and for their children and grandchildren's future. But when they die, the federal government can take more than half of all their assets and savings because of the estate tax. This is simply unfair.

When my grandparents died there was some small amount of money left to the children and grandchildren. The total probably didn't amount to $10,000 and that was from both sides of the family. When my father died he had already distributed his money to his children and grandchildren . The total he gave out was under $100,000 Again nothing of interest to the IRS .

Now we fast forward. A number of years ago I was widowed. I eventually remarried and then came my awakening. I went to do a prenuptial. This meant a lawyer. Now I have nothing against lawyers my companies employs lots of them,, corporate lawyer, a tax attorney, an employment attorney, a regulatory attorney. a real estate attorney and now a death attorney. My feeling is that when I am on my death bed a lawyer will be standing there telling me that I can't die until I finish my government death forms and pay my taxes.

As a result of meeting with an attorney for the pre-nuptial, I told my children the best thing I could do for them was to make sure I left them my house with a big mortgage and outstanding credit card balances.

If they didn't want to be burdened I needed to spend all my money and make sure my companies had relatively little value. Because you see I made it. I am successful. When I die I will leave an estate that is probably going to be more money than my father may have made in his lifetime. After I grew up I understood that as a kid we were poor. We lived in a five story walk-up tenement in upper Manhattan.

I have been in the health care business over forty years. I believe I do good work helping the people in my community. I pay my taxes both personal and corporately, maybe not with a smile but certainly I understand that the country that gave my grandparents and the succeeding generations a chance, needs to tax its citizens to continue to be this country.

My older son is my partner and I really have a hard time with the thought that he might have to sell my life work achievement in order to pay the estate taxes that will be due.

More than 70% of family business and farms do not survive through the second generation. 87% do not make it through the third generation. With rates between 37% and 55%, the estate tax punishes life-long habits of savings, discourages entrepreneurship and punishes families.

The generation-skipping tax or GST is a tax on assets that you pass on to your grandchildren at an effective 80% rate, once you have utilized your GST exemption.

Within the definition that the family controls the business either by stock or through management, 91% of all businesses in America are family owned.

- Death should not be a taxable event! (You must pay the tax nine months after the date of death in cash.)

- Families should not be punished for saving (the more they save... the more tax is paid at death.)

- Taxes should not have to be paid on assets that have been taxed as many as two, three or more times before (e.g., income, capital gains, payroll, etc.)

- A death tax rate of 55% cannot be justified when the highest income tax rate is 39.6%; nor can a tax of 80% on gifts to grandchildren.

- The estate tax produces less that 1% of the revenue and it could be phased out over time with a reduction in the rate of tax each year.

Woman statistically out live men and therefore they are the one's that have to pay the estate tax.

Public companies don't die so they do not pay the tax. Only families pay the estate tax. Public companies have grown by acquiring the smaller family businesses that have had to be sold to pay the 55% death tax.

Eliminating the estate tax will not cost the U.S. Treasury money. Personally I could very easily do without another STEALTH bomber or Aircraft Carrier. The tax makes up less than 1 percent of all annual federal revenues. The individual income tax alone raised more revenue in 1998 than the tax has raised during the entire 20th century.

89% of all taxable estates filed in 1995 were $2.5 million or less in size.

54% of all estate taxes paid in 1995 came from net taxable estates of $5 million or less.

Japan has an inheritance tax of 70%, but after credits and exemption it is an effective tax rate of 30.3%. 'The United States has the highest rate of estate tax in the world at the rate of 55% and an effective rate of 44%.

In a study done by The Tax Foundation it was found that to match the disincentive effect of the estate tax, income taxes would have to be raised up to roughly 70% or almost twice the top marginal income tax rate of 39.6%

NAWBO's position is to repeal the Estate Tax in its entirety. The so called death tax creates a disincentive to expand a business, create jobs, and often, literally taxes the family business right out of the family. Many business owners would add more jobs over the coming years if death taxes were eliminated. We know that right now this is Utopian position therefore we are proposing :

Congress should amend the estate and gift-tax code to:

1_ Increase the exemption to $760,000 and index it thereafter to allow a family-owned business to be passed on to family members free of estate and gift taxes. Surely we can get to the $1,000,000.00 exemption level before 2006.

2- Tax trusts on their taxable income at the same rate brackets as for a single individual

3- Make retirement -plan assets of up to $ 1.5 million dollars per person exempt from estate tax since all such amounts are also subject to income tax: and reinstate the $ 1 million exemption per descendent for generation-skipping tax purposes.

Fifteen states have repealed inheritance taxes. Four states (Connecticut, Iowa, Louisiana and New York) most recently in 1997

In a study done by The Center for the Study of Taxation, it was determined that if gift, estate and generation- skipping taxes had been repealed in 1971, by the year 1991 there would have been 262,000 more jobs, $46.3 billion more in GDP and $398.6 billion more in capital.

90 trade and industry organizations have formed the Family Business Estate Tax Coalition, whose sole purpose is to repeal the "Death Tax".

"The Grandchildren's Tax"

Did you know that if you want to give a gift to your grandchildren you could pay an 80% tax to do so! What if your grandchild has worked hard to get through college and needs a car to start his or her new job, and you want to help him purchase that car. You can only contribute $10,000 toward the purchase of that car and not have gifted him or her anything else that year, or else you may pay 80% more for the tax. You can only gift a maximum of $10,000 a year, in assets, cash or services to your grandchildren without incurring the grandchildren's tax. Is it fair that you spend years saving your assets, paying payroll, income and capital gains tax, and now when a family member needs help, you cannot do so without paying an additional tax on assets you have already paid taxes on before; at least twice before? This tax is designed to discourage you from passing on assets to your grandchildren, skipping the level of tax that would be paid by your children. The grandchildren's tax, referred to in the tax code as generation skipping tax, makes sure that assets get taxed again and again at each generation. How does that encourage people to save? The tax code provides for a $1 million lifetime exemption, but you need to plan your estate properly to take full advantage of this. Shouldn't a tax law encourage families to save assets and help each other? The generation skipping tax creates an incentive for families to spend their earnings or to give to strangers rather than encourage them to help their own family members.

I appreciate the Committee considering these issues and the suggestions I have offered. Please know that the leadership of NAWBO and its members look forward to hearing from you and working with you. NAWBO will assist your efforts in any way that we can . Thank you very much for the time you have given me.

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House of Representatives
106th Congress
Committee on Small Business
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May 12, 1999

IMPACT OF THE ESTATE TAX ON SMALL BUSINESS

By: Stephen M. Breitstone

The Perils of Small Business

I am an attorney practicing in Mineola, New York. The principal focus of my practice relates to the tax, business, and estate planning principally for small and closely held business. I have been practicing law since 1982 when I graduated from Benjamin N. Cardozo School of Law of Yeshiva University, New York. I also have my Bachelor of Science from New York University School of Business and Public Administration and an Masters in Law from New York University School of Law where I specialized in tax law. In addition, I was an adjunct professor at the Cardozo Law School in the area of taxation.

Although I had a very successful law practice principally representing large corporate clients throughout most of the 1980's, I choose to leave that behind in order to move to Long Island and build my practice at a highly respected law firm where I would work more with small and closely held businesses. Our law practice takes many businesses from their early stage as start up companies and helps them to grow and to prosper. Many successful small companies become large companies and some become public companies. However, the overwhelming majority of these companies fail to achieve their goals. It is the primary focus of my practice to help these companies to navigate the perilous regulatory legal and economic environment where the odds are clearly stacked against them.

Having worked closely with many founders of closely held businesses through all stages of the businesses development I have come to learn that the closely held business is the consummate example of the American dream. The small business owner notoriously begins as the underdog. Knowing full well that the overwhelming majority of small businesses fail they are willing to risk their personal and financial fortunes and any perception of job security they may have had in another occupation, to be their own boss, and to obtain a level of independence and freedom to control their own destiny, which can only be obtained by an extraordinary degree of perseverence, ingenuity and hard work.

Only in the United States can anybody with the ingenuity and the willingness to make the sacrifices necessary to embark upon the formation and ownership of a small business do so if they choose.
Yet, these small businesses are almost always at an enormous disadvantage compared to their competitors. They do not have the capital base that affords larger established entities the ability to weather temporary economic downturns, delays resulting from excessive regulatory intervention, and often predatory competitive forces in the market place. Certainly, your average small business could not afford to make a mistake in its product line or development as large corporate concerns can do time and time again.

Nevertheless, small and closely held business are responsible for much of the growth and prosperity in our economy. I understand the majority of job creation in this country comes from small business. Perhaps most important, the wealth of ingenuity and technologic innovation in our economy is derived from the entrepreneurial efforts of small business owners.

The Burdens of the Estate Tax Fall Principally Upon Small Business

The adverse impact of the estate tax is born disproportionately by successful small and closely held businesses. Large corporations usually do not have to worry about the estate tax. Large public corporations typically have a multitude of shareholders with no individual shareholder owning a major percentage of the stock of the corporation. Therefore, they need not be concerned with funding the estate tax obligations of their shareholders since the burden if any falls upon the shareholders not upon the corporation. Typically, the stock of a large corporation can be readily disposed of in an established securities exchange so the shareholders have little concern regarding the liquidity necessary to fund a 55 percent estate tax obligation.

Ownership of small and closely held business, on the otherhand, typically an illiquid investment. The discount rates that apply to stock of small and closely held businesses are far greater than those applicable to public corporations.

The ability to avoid the burdens of the estate tax puts large corporate America at a substantial competitive advantage over small businesses. As mentioned above relatively few small businesses survive at all. For the fortunate few who are able to survive the competitive forces and all of the other hurtles they must face, the estate tax imposes a potentially crippling financial obligation upon small and closely held businesses at the time when they can least afford to shoulder the burden.

Closely held businesses rarely survive the transition to the next generation. Often the success of the business is very much tied to the personal efforts of the founder. The death of a founder can result in the business failing altogether. For those businesses that are capable of surviving (a mere 3 and 10 family businesses survive the transition from the first generation to the second and less than 15% survive into the third generation) substantial costs may have to be incurred to hire high level management that can enable the business to carry on. The death of a founder may mean loss of important contacts and relationships which are vital to the survival of the business.

If the business is capable of enduring these events, it will be burdened with a liability that can amount to 55% of its worth. That type of liability, even if incurred for capital expansion substantially increases the risk, but it also increases the returns . associated with the business.

However, the payment of an estate tax burden, unlike an investment in additional capital, yields no return to the company. This is a one way street. The payment of an estate tax can deplete the capital of the company necessary for its very survival.

Moreover, throughout the life of a business, its owners must constantly choose between reinvesting profits in the future growth and expansion of the business, or drawing the maximum short term profits. It is well recognized in the tax law that owners of closely held business often are undercompensated for their efforts. They must choose between making payroll, paying vendors, financing capital expansion, on the one hand, and drawing for themselves. For many small and closely held business owners, virtually all of their net worth may be tied up in the business. The potential economic calamity wrought by the imposition of the estate tax can be ruinous and certainly serves as a major disincentive for investing in the business for the long term.

Finally, their are numerous techniques that have been developed by practitioners such as myself, for avoiding the estate tax through inter vivos transfers. Unfortunately, for the small business owner, making those transfers may be a luxury they cannot afford. For the very wealthy, inter vivos transfers can be made of a substantial portion of their personal worth without affecting lifestyles and the ability to provide for health care and other needs. However, for small business owners, if substantial inter vivos transfers are made, they may have to give up their financial independence, which they have worked so hard to achieve, as well as their ability to maintain their lifestyles and provide for their health care needs.

<u>The Estate Tax System Suffers from Numerous Technical Flaws.</u>

Meltzer, Lippe,Goldstein & Schissel, P.C.

There are many flaws in inequities in the estate tax system. As pointed out in the report of the Joint Economic Committee dated December, 1998 (THE ECONOMICS OF THE ESTATE TAX), the existence of the estate tax prompts a multitude of inter vivos transactions designed to minimize or to avoid estate tax liabilities -- not usually available to the small business owner. In addition, many economic distortions result from the estate tax. Transactions that make little economic sense are often contrived to avoid estate taxation. Transactions that make good economic sense are often quashed because of estate tax implications. The Internal Revenue Service, in its infinite wisdom often presume tax avoidance in inter family transactions where none was intended. The effect of this is often that transactions among family members are more heavily taxed that similar transactions among unrelated parties.

Finally, the income and estate tax systems do not work in harmony with each other. There are many disparities. Transactions are often treated inconsistently for income and estate tax purposes. Although tax avoidance opportunities may arise from such disparities, many economic distortions arise as well.

These concerns can be exemplified as follows: A successful company that sells electronic components has recently made a transition to internet based sales. This was done as a result of the ingenuity of the younger executives. One is the son of the current owner and the other is unrelated. The current owner wishes to keep the younger executives with the company by giving them an economic stake. Eventually, it is hoped the younger executives will acquire ownership of the company. I was able to devise a structure which would allow the younger executives to participate in the economic growth of the company. However, much to the dismay of my clients, te transfer to the son is subject to a gift tax even though it is on exactly the same terms as the transfer to the non-family member. This is a function of the chapter 14 valuation rules set forth in Section 2701 of the Internal Revenue Code.

The Case for Burying the Estate Tax

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Executive Summary

Perhaps no section of the tax code does as much societal damage while generating relatively little revenue as the estate tax.

- Estate taxes generate less than one percent of federal revenues.
- Estate tax compliance costs the economy almost as much as the revenue raised. Such compliance costs are a deadweight loss to society.
- High marginal estate tax rates (from 37% to 55%) often force heirs to sell family farms or businesses just to pay the estate tax bill.
- Estate taxes strike families when they are at their most vulnerable: along with the family member, families can lose what the family member built.
- High marginal estate tax rates also discourage savings and investment, reducing economic growth.

Further, there is neither social nor economic justification for the estate tax.

- Estate taxes today are far out of line with historical precedent. Throughout most of U.S. history, estate taxes were temporary measures during wartime, and were eliminated when hostilities ceased.
- The largest estates do not even pay the highest tax rates. Typically, owners of small businesses and family farms who amass wealth through a lifetime of hard work and thrift pay significantly higher marginal estate tax rates than the very rich, particularly those who inherited their wealth.

Today, estate taxes reach much more deeply into the middle class than ever before.

- Today, estates over $650,000 are taxed, compared to $9 million (in today's asset dollars) in 1916.
- Although tax schedules give the impression that the estate tax begins at 18 percent, in fact, most people begin paying at a marginal rate of 37 percent on the first dollar of taxable estate.

Eliminating the estate tax altogether would eliminate all these complexities and injustices with no revenue loss to the Treasury. In fact, after ten years, eliminating the estate tax would produce sizeable economic gains, actually increasing federal revenues above the current baseline, according to the analysis in this study.

In the 105th Congress, more than 50 bills dealing with estate taxes were introduced. Proposals ranged from relief directed to specific groups of taxpayers, such as farmers and closely-held businesses, to the outright elimination of estate and gift taxes. More proposals have already been introduced during the 106th Congress.

In order to reduce compliance costs, social injustice, and hinderances to economic growth, Congress should make estate tax policy a priority for action. Serious reduction or

The Case for Burying the Estate Tax

By: Gary Robbins, Senior Research Fellow,
and Aldona Robbins, Senior Research Fellow

Introduction

Estate taxation is one of the most arcane and obscure parts of the federal tax code. Until recently it was the almost exclusive headache of the super rich, their tax attorneys and their estate planners. However, a strong economy, an ever-widening distribution of wealth – both positive developments – coupled with short-sighted tax policy are extending the reach of estate taxes. About 2.8 percent of those who died in 1992 left estates large enough to file an estate tax return. That percentage should at least double by 2002.

Estate taxes even threaten the middle class. Average Americans who purchased homes 20 or 30 years ago, own a farm or built up a family business could find their estates large enough to be taxed. And high marginal tax rates (37% on estates over $650,000 up to 55% on estates over $3 million) often force heirs to liquidate assets to pay the estate tax bill.

Not surprisingly, the plight of family farms and businesses has caught the attention of policy makers. Over 50 bills dealing with estate taxes were introduced during the 105th Congress. Proposals ranged from relief directed to specific groups of taxpayers, such as farmers and closely-held businesses, to increasing the size of estates exempt from tax, to the outright elimination of estate and gift taxes. More proposals will undoubtedly be considered during the 106th Congress.

"Over 50 bills dealing with estate taxes were introduced during the 105th Congress."

The purpose of this study is to shed some light on this little understood and extremely complex tax. The first section traces the development of federal estate taxes in the United States from colonial times to the present. Next comes a discussion of today's estate tax, including who pays it. The third section examines how estate taxes affect the economy, and the last section presents estimates of how eliminating the estate tax would affect the economy and federal budget.

U.S. Estate Taxes: An Historical Perspective

Death taxes date back almost three thousand years. As early as 700 B.C., there appears to have been a 10 percent tax on the transfer of property at death in Egypt.[1] In the first century A.D., Augustus Caesar imposed a tax on successions and legacies to all but close relatives.

Transfer taxes during the Middle Ages grew out of the fact that the sovereign or the state owned all assets. Although the king owned all real property in feudal England, he did grant its use to certain individuals during their lifetimes. When they died, the king would let the estate retain the property upon payment of an estate tax.[2]

Of course, the principle of sovereign ownership is diametrically opposed to a system of individual property rights, as we have today in the United States, and is no longer the basis for taxing transfers of wealth. But other rationales have taken its place. What follows is a brief history of U.S. estate taxation. The discussion centers around three periods: early federal estate taxes (1797 to 1915); the development of the modern estate tax (1916-1975) and the restructuring of federal estate taxes (1976 to the present). Tables 1, 2 and 3 summarize major features of estate tax legislation from these three periods.

Early Federal Estate Taxes: 1797 to 1915

In the United States, the tradition of taxing assets at death began with the Stamp Act of 1797. While the first Stamp Act on tea helped precipitate the Revolutionary War, the second was far less dramatic. Revenues from requiring a federal stamp on wills in probate

Table 1
Early Federal Estate Taxes 1797 to 1915

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

[illegible]	[illegible]	[illegible]
Stamp Act of 1797	Federal stamps required on receipts and discharges from legacies and intestate shares.	To finance undeclared naval war with France
1802	Stamp Act repealed.	
Revenue Act of 1862	Tax on legacies and distributive shares of personal property from estates over $1,000; rates ranged from 0% for surviving spouse bequests to 0.75% for distributions to ancestors, lineal descendents and siblings to 5% for those to distant relations and unrelated persons.	To finance Civil War
Internal Revenue Law of 1864	Added a succession tax, a tax on bequests of real property; increased legacy tax rates on personal property transfers; first gift tax applied to real property transfers of less than adequate consideration made during decedent's life. Also introduced an exemption for small estates; special treatment for surviving spouse bequests; tax deductions for bequests to charitable organizations.	To finance Civil War
1870	1864 tax repealed .	
1874 Supreme Court Ruling ***(Scholey v. Roe)***	The Court disagreed with the taxpayer's contention that death taxes were direct taxes that must be apportioned according to the census.	Upheld the constitutionality of legacy and succession taxes.
Income Tax Act of 1894	Treated gifts and inheritances as income and taxed them as such.	
1895 Supreme Court Ruling ***(Pollock v. Farmers' Loan and Trust Company)***	The Court ruled the Income Tax Act of 1894 unconstitutional because it taxed gains from real estate, thereby constituting a direct tax which had to be apportioned among the states according to the census.	Set the stage for passage of the 16th Amendment to the Constitution which expressly authorizes the federal government to impose an income tax without census apportionment.
War Revenue Act of 1898	Death tax applied to value of personal property in a gross estate (after a $10,000 exemption) instead of bequests; property going to a surviving spouse excluded from tax; rates graduated from 0.74% to 15%.	To finance the Spanish American War
1900 Supreme Court Ruling ***(Knowlton v. Moore)***	The Court reaffirmed its earlier decision that the estate tax was an indirect tax and rejected the contention that death taxes were the exclusive prerogative of the states.	
1902	1898 tax repealed.	

were used to pay off debts incurred during the 1794, undeclared naval war with France. Congress repealed the Stamp Act in 1802.

Not until the Civil War did the federal government again turn to death taxes for revenue. Unlike the previous documentary stamp tax, the Tax Act of 1862 imposed a federal *inheritance* tax. Heirs who received legacies and personal property from estates worth more than $1,000 (roughly $1 million in today's dollars) had to pay a graduated tax based on family relationship.[3] Rates ranged from 0.75 percent for ancestors, lineal descendants and siblings up to 5 percent for distant relations and unrelated persons.

To help pay mounting Civil War costs, Congress increased the inheritance tax rates and added a succession tax in 1864.[4] When the need for added revenue subsided after the war, the inheritance tax was repealed in 1870.[5]

In 1874, a taxpayer challenged the legality of the Civil War death taxes, arguing they were direct taxes which, under the Constitution, must be apportioned among the states according to the census. The Supreme Court disagreed saying that direct taxes pertained to capitation (head) taxes and taxes on land, houses and other permanent real estate.[6]

Another legal decision bearing on, but not directly related to, death taxes concerned The Income Tax Act of 1894, which included gift and inheritances as income subject to tax. The Supreme Court struck down the whole bill because the tax was imposed on, among other things, real estate gains and, therefore, considered a direct tax.[7] This decision is particularly notable because it set the stage for the Sixteenth Amendment which, in short, allows the federal government to tax any thing it wants, any time it wants, any way it wants.

Financing for the Spanish-American War gave rise to another death tax in 1898. A tax, ranging from 0.74% to 15%, was imposed on the value of personal property in a gross estate. Estates under $10,000 (roughly $6 million in today's dollars) and property passing to surviving spouses were excluded.[8]

The Supreme Court upheld the 1898 Act by ruling that estate taxes, like inheritance taxes, were not direct taxes and did not have to be apportioned among the states.[9] Congress repealed the estate tax in 1902.

Evolution of the Modern Estate Tax: 1916 to 1975

Another form of death tax did not appear until 1916. As worldwide conflict cut into trade tariffs, Congress turned to another revenue source—the income tax —made possible by the Sixteenth Amendment to the Constitution.

The Revenue Act of 1916, which introduced the modern day income tax, also contained an estate tax with many features of today's system. Graduated tax rates were applied to the *net estate*, that is, *gross estate* less deductions. Gross estate included personal and real property, life insurance payable to the estate, and certain transfers that could occur during a person's life or after death. Jointly-owned property was part of the estate unless the surviving co-owner could prove he or she had helped pay for its acquisition. Deductions were allowed for administrative costs, debts, claims, funeral costs and support of decedent's dependents during administration of the estate. After an exemption of $50,000 (almost $9 million in today's dollars), tax rates started at 1% and climbed to 10% on estates over $5 million. [See Table 4 for a summary of estate tax exemptions and tax rates since 1916.]

Defense demands after the U.S. entered World War I required even more revenue. In 1917, estate tax rates were more than doubled and two more brackets were added.

In 1918, Congress reduced the tax rates on estates under $1 million and added charitable contributions to the list of allowable deductions. But the estate tax base was expanded by including the value of a spouse's dowery and life insurance proceeds over $40 million going to the estate.

Table 2
Development of Modern Estate Tax, 1916 to 1975

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

[illegible]	Description	Purpose/Importance
Revenue Act of 1916	Introduced modern estate tax which applied to net estate (gross estate minus deductions); tax rates started at 1% of the first $50,000 of net estate to 10% on estates exceeding $5 million; gross estate included personal and real property, life insurance payable to estate, certain lifetime transfers and transfers which took affect on or after death; all joint property was included unless there was evidence that the co-owner gave support; deductions allowed for administrative costs, debts, claims, funeral costs and support of decedent's dependents during estate's administration.	To help offset revenue shortages caused by reduced U.S. trade tariffs due to World War I.
Revenue Act of 1917	Increased rates and added two brackets; estate tax rates went from 2% on net estates below $50,000, to 22% on net estates between $8 and $10 million, and 25% on those above $10 million. Estates of those who died in military service were not taxed.	To help offset defense costs of World War I.
Revenue Act of 1918	Reduced rates on estates under $1 million; expanded estate tax base by including spouse's dower rights and life insurance proceeds over $40,000; allowed a deduction for charitable contributions.	Compromise in debate between and House and Senate between cutting rates versus replacing estate tax with an inheritance tax.
Revenue Act of 1924	Increased top rate to 40% on estates over $10 million; allowed credit against federal estate taxes for state death tax of up to 25% of federal liability; expanded estate tax base by including revokable transfers; added a gift tax with same rate schedule along with exclusions of $50,000 over lifetime and $500 a year for each donee.	
Revenue Act of 1926	Repealed gift tax; lowered top rate to 20% on estates over $10 million; increased exemption to $100,000; increased the maximum credit for state death taxes to 80% of Federal liability.	Response to stiff opposition toward estate and gift taxes.
1929 Supreme Court Ruling ***(Bromley v. McCaughn)***	Court held that gift tax was an excise tax which fell in the category of indirect taxes.	
Revenue Act of 1932	Raised almost every estate tax rate; added two new brackets; dropped estate exemption from $100,000 to $50,000; reintroduced gift tax with rates 75% those of estate taxes; set lifetime gift exclusion at $50,000 and annual exclusion of $5,000 per donee.	To increase federal revenues that had been reduced by the Depression.
Revenue Act of 1934	Raised top estate tax rate to 60% on estates over $10 million.	Extension of social policies that aimed to redistribute income.
Revenue Act of 1935	Raised top estate tax rate to 70% on estates over $50 million; reduced estate and gift lifetime exclusions to $40,000.	Extension of social policies that aimed to redistribute income
Revenue Act of 1940	Added a 10% surtax to income, estate and gift taxes.	To pay for increased military preparedness as war broke out in Europe.
Revenue Act of 1941	Increase in estate tax rates range from 3% on net estates under $40,000 up to 77% on estates over $10 million.	
Revenue Act of 1942	Created a $60,000 estate tax exemption and gift tax exclusions of $30,000 lifetime and $3,000 annually; expanded estate tax base through inclusion of insurance paid for by decedent; excluded community property from gross estate only to the extent that the surviving spouse could be shown to have contributed.	Tried to correct the perceived inequity between community property and noncommunity property states.
Revenue Act of 1948	Allowed a marital deduction equal to the value of all property passing to a surviving spouse up to a maximum ½ of the adjusted gross estate in noncommunity property states.	Replaced 1942 community property rules that were complex and unsuccessful.
Internal Revenue Code of 1954	Changed estate taxation of life insurance to include most proceeds.	

Increases in estate taxes made in 1924 were, for the first time in U.S. history, not related to war. Despite sizable budget surpluses, Congress hiked the top rate from 25% to 40% on estates over $10 million and introduced a *gift tax*. Like the estate tax, the gift tax is a levy on the transfer of property from one person to another. While the estate tax aims at transfers after death, the gift tax applies to transfers during the donor's lifetime. The 1924 gift tax had the same rate schedule as the estate tax, a lifetime exclusion of $50,000 and an annual exclusion of $500 for each donee. Gifts over $500 required the donor to file a return.[10]

Growing resistance to estate and gift taxes prodded Congress to reduce estate tax rates, double the exemption to $100,000 (almost $9 million in today's dollars) and repeal the gift tax in 1926. Even so, the Supreme Court still responded to an earlier challenge by ruling in 1929 that the gift tax was an indirect tax and, therefore, constitutional.[11]

As the Great Depression cut into federal revenues, Congress reintroduced the gift tax, increased estate tax rates, reduced the exemption to $50,000 and added two new brackets in 1932. Gift tax rates were set at three-fourths those of estate taxes, a ratio maintained until 1976. Continuing economic woes coupled with socialistic policies of the era led to more increases in death taxes. By 1935, the top estate tax rate hit 70% on estates over $50 million.

Still more increases came with the onset of World War II. A 10% surtax on income, estate and gift taxes was added in 1940. In 1941, estate tax rates were increased, with the top rate hitting 77% on estates over $10 million.

Differences between *community property* and *noncommunity property* states created a new wrinkle that preoccupied estate tax policy for the rest of the decade. By law, each spouse owned one-half of all property acquired during marriage in community property states. When one spouse died, only half the community property would be subject to estate tax. In noncommunity property states, however, a spouse owned property only to the extent that he or she helped acquire it and only that portion could be excluded from the estate.

"Increases in estate taxes made in 1924 were, for the first time in U.S. history, not related to war."

Congress first tried to fix this inequity in 1942 by applying noncommunity property rules to estates in community property states. That is, only jointly-owned property to which the surviving spouse contributed could be excluded from an estate. But, the resulting backlash forced Congress to move in the other direction with a marital deduction that treated jointly-owned property as community property states did. Starting in 1948, surviving spouses in noncommunity property states could deduct up to half the value of all property passing to them from the gross estate.

While the Internal Revenue Code of 1954 overhauled the federal income tax, it made a seemingly minor structural change to estate taxation. Specifically, it expanded the tax base to include most life insurance proceeds, which could substantially raise an estate's tax bill.

Retooling Federal Transfer Taxes: 1976 to the Present

The next major change to federal transfer taxes came twenty-two years later when the Tax Reform Act of 1976 unified estate and gift taxes. Gifts, which had been taxed at 75 percent of estate tax rates, were made subject to the same, graduated rate structure. That is, transfers made at death were treated as the last taxable gift of the deceased donor. The gift tax continued to be cumulative, that is, each successive gift was added to earlier gifts which could push the transfer into a higher tax bracket. The new rate structure started at 18% for transfers over $10,000 (about $50,000 in today's dollars) and rose to 70% for those over $5 million (about $24 million in today's dollars).

The 1976 Act also combined the previously-separate exemptions for estate and gift taxes into a single, *unified estate and gift tax credit*. The credit could be used to offset gift tax liability during the donor's lifetime. Whatever remained at death would offset the estate tax liability. The unified credit was set at $29,800 for transfers before 1978, rising to $46,800

Table 3
Restructuring Federal Transfer Taxes 1976 to Present

Sources: Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97, Joint Committee on Taxation, "Summary of Revenue Provisions of H.R. 2014 ("Taxpayer Relief Act of 1997"), August 1, 1997 and John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995.

[illegible]	[illegible]	Purpose/Importance
Tax Reform Act of 1976	Unified estate and gift tax with one graduated rate of tax and a single estate and gift tax credit; rates were graduated up to 70% on taxable estates over $5 million; the credit was $42,500 (same as $161,000 exemption) for transfers made in 1980 and $46,830 ($175,000) thereafter; added new tax on generation skipping transfers (GST); set up a carryover basis rule for inherited property so that the basis for the heir(s) was the asset's value at the donor's date of death after adjustments; special valuation and payment rules for small businesses and farms; increased marital deduction to ½ adjusted gross estate or $250,000.	Biggest structural change was unification of estate and gift taxes.
Revenue Act of 1978	Suspended the effective date of carryover basis rules until 1980; set up rules so that surviving spouse who "materially participated" in operating a family farm or business could treat some of appreciated value as cash contributed by spouse.	
Crude Oil Windfall Profits Tax Act of 1980	Repealed 1976 carryover basis rules retroactive to effective date.	Added as amendment to tax bill.
Economic Recovery Tax Act of 1981	Increased unified credit to $192,800 ($600,000 exemption); cut the top rate from 70% to 50%, phased in over 3 years, on transfers over $2.5 million; allowed unlimited marital deduction; included only ½ joint property in otherwise fully-valued pension benefits; simplified and liberalized rules on closely held businesses and family farms; increased annual gift exclusion to $10,000; repealed orphan deduction; delayed effective date of GST rules another year.	Changes reduced the number of taxable estates.
Deficit Reduction Act of 1984	Froze top transfer tax rate at 55% until 1988; liberalized rules on estates containing closely held businesses.	To raise revenue for deficit reduction.
Tax Reform Act of 1986	Repealed GST tax retroactive to 6/1/76 and replaced it with a single rate set at the top estate tax rate (then 55%); introduced 50% exclusion for employee stock ownership plans (ESOP)	
Omnibus Budget Reconciliation Act of 1987	Froze top transfer tax rate at 55% until 1993; phased out graduated rates and unified credit for estates over $10 million; closed a perceived loophole whereby an estate could reduce its tax liability through a series of ESOP sales and purchases; "estate freeze" transactions provisions caused the total value of transferred property to be included in gross estate as property in which the decedent retained an interest.	To raise revenue for deficit reduction.
Technical and Miscellaneous Revenue Act of 1988	Removed marital deduction when spouse is not a U.S. citizen unless the transfer uses a qualified domestic trust; expanded and clarified estate freeze rules; amended alternate valuation rules for family farms.	
Revenue Reconciliation of 1989	Amended provisions dealing with GST and noncitizen spouses; dropped ESOP exclusion.	
Omnibus Reconciliation Act of 1990	Retroactively repealed "estate freeze" rules from 1987 and 1988; added new rules regarding whether a transfer constituted a gift.	To raise revenue for deficit reduction.
Omnibus Reconciliation Act of 1993	Restored the top two transfer tax rates to 53% and 55% retroactive to 12/31/92.	To raise revenue for deficit reduction.
Taxpayer Relief Act of 1997	Increased unified credit so that exemption is $625,000 in 1998, rising to $1 million in 2006 and after; lowered estate taxes on closely held businesses and family farms.	First general estate tax relief since 1981.

for transfers after 1980. These credit amounts translated into exemptions of $120,000 and $175,000, respectively. This also marked the first increase in the $60,000 exemption since 1954. Donors could still make annual gifts of up to $3,000 without paying tax.

Capital gains treatment of inherited property also was substantially changed. Before 1976, the *basis*, or acquisition cost, of inherited property, such as stock or real estate, was the fair market value at the time of transfer. An heir immediately selling the property would have no capital gains consequences because the acquisition and sales price would be the same. However, the 1976 Act contained a *carryover basis* rule which meant that the heir's basis was the same as the decedent's. On top of estate taxes, which could take between 18 and 70 percent, heirs also could incur a potentially large capital gains tax bill where there had been none.[12]

Another major change was a new tax on *generation-skipping transfers*. These transfers allow one generation, usually the donor's children, to use the property during their lifetime but give ownership to another generation, usually the donor's grandchildren. Before 1976, estate taxes usually were imposed on the second transfer (ownership) but not on the first. Tax reform added complicated rules that taxed both transfers.[13]

The Tax Reform Act of 1976 did provide some relief from estate taxes through an increase in the marital deduction to $250,000[14] and special rules for *closely-held businesses* or family farms.[15]

In the face of ever-rising tax burdens and economic stagflation, the Congress lowered tax rates for individuals and corporations in the Revenue Act of 1978. The bill also suspended the effective date of the estate tax rules on carryover basis until 1980 and gave some relief to surviving spouses who helped operate the family business or farm.[16] Carryover basis rules were finally repealed in 1980.

More estate tax relief came with the Economic Recovery Tax Act of 1981 (ERTA). A phased-in increase of the unified estate and gift tax credit from $46,800 (same as an exemption of $175,000) to $192,800 ($600,000) removed a lot of estates from the tax rolls.[17] A cut in the top estate, gift and generation-skipping transfer tax rates from 70 to 50 percent, phased in over three years, lowered the tax bill on estates and other transfers. ERTA also allowed an unlimited marital deduction and increased the annual gift exclusion from $3,000 to $10,000. Rules affecting family businesses or farms were made simpler and more liberal.

Between 1984 and 1993, seven tax bills essentially tinkered with the estate and gift tax system. The most significant structural change occurred with the Tax Reform Act of 1986 which revamped generation-skipping transfer taxes. Other changes were designed as "revenue raisers" to help close the federal budget deficit. For example, the Deficit Reduction Act of 1984 froze the top transfer rate at 55 percent until 1988, instead of letting it drop to 50 percent in 1985. The Omnibus Budget Reconciliation Act (OBRA) of 1987 further delayed the drop until after December 31, 1992. While the reduction in the top rate did take effect at the start of 1993, the budget bill of 1993 retroactively restored the top two rates.

After more than a decade of bills that largely increased estate taxes, Congress recently provided some relief with the first increase in the unified credit since 1987. Beginning in 1998, the unified credit is set to increase from $600,000 to $1 million by 2006.

Table 4
Estate Tax Filing Requirements and Tax Rates, 1916-2006

[1] Adjusted for the change in wealth, as measured by gross domestic product, between 1916 through 1998. Nominal GDP is assumed to increase by 5 percent a year thereafter.

[2] Refers to the top rate on the supplemental estate tax in place from 1932 to 1953.

[3] Refers to the top bracket amount on the supplemental estate tax in place from 1932 to 1953.

[illegible]	[illegible]				[illegible]	
	Statutory	1998 Wealth[1]	Initial Rate	Top Rate[2]	Statutory[3]	1998 Wealth[1]
1916	50,000	8,845,267	1%	10%	5,000,000	884,526,749
1917	50,000	7,070,395	2%	25%	10,000,000	1,414,078,947
1918	50,000	5,590,117	1%	25%	10,000,000	1,118,023,407
1919	50,000	5,081,324	1%	25%	10,000,000	1,016,264,775
1920	50,000	4,662,473	1%	25%	10,000,000	932,494,577
1921	50,000	6,132,382	1%	25%	10,000,000	1,226,476,462
1922	50,000	5,762,466	1%	25%	10,000,000	1,152,493,298
1923	50,000	5,016,103	1%	25%	10,000,000	1,003,220,537
1924	50,000	5,039,625	1%	40%	10,000,000	1,007,924,971
1925	50,000	4,582,942	1%	40%	10,000,000	916,588,486
1926	100,000	8,800,000	1%	20%	10,000,000	880,000,000
1927	100,000	8,993,305	1%	20%	10,000,000	899,330,544
1928	100,000	8,800,000	1%	20%	10,000,000	880,000,000
1929	100,000	8,282,852	1%	20%	10,000,000	828,285,164
1930	100,000	9,437,541	1%	20%	10,000,000	943,754,116
1931	100,000	11,253,403	1%	20%	10,000,000	1,125,340,314
1932	50,000	7,335,836	1%	45%	10,000,000	1,467,167,235
1933	50,000	7,649,110	1%	45%	10,000,000	1,529,822,064
1934	50,000	6,523,217	1%	60%	10,000,000	1,304,643,399
1935	40,000	4,704,569	2%	70%	50,000,000	5,880,711,354
1936	40,000	4,113,684	2%	70%	50,000,000	5,142,105,263
1937	40,000	3,746,231	2%	70%	50,000,000	4,682,788,671
1938	40,000	4,003,539	2%	70%	50,000,000	5,004,423,749
1939	40,000	3,742,155	2%	70%	50,000,000	4,677,693,145
1940	40,000	3,398,261	2%	70%	50,000,000	4,247,826,087
1941	40,000	2,714,317	3%	77%	10,000,000	678,579,321
1942	60,000	3,192,178	3%	77%	10,000,000	532,029,703
1943	60,000	2,601,392	3%	77%	10,000,000	433,565,305
1944	60,000	2,348,002	3%	77%	10,000,000	391,333,637
1945	60,000	2,311,183	3%	77%	10,000,000	385,197,133
1946	60,000	2,317,412	3%	77%	10,000,000	386,235,400
1947	60,000	2,108,978	3%	77%	10,000,000	351,496,321
1948	60,000	1,912,703	3%	77%	10,000,000	318,783,834
1949	60,000	1,926,273	3%	77%	10,000,000	321,045,556
1950	60,000	1,751,039	3%	77%	10,000,000	291,839,783
1951	60,000	1,518,563	3%	77%	10,000,000	253,093,906
1952	60,000	1,438,528	3%	77%	10,000,000	239,754,601
1953	60,000	1,358,588	3%	77%	10,000,000	226,431,393
1954	60,000	1,352,887	3%	77%	10,000,000	225,481,248
1955	60,000	1,242,727	3%	77%	10,000,000	207,121,176
1956	60,000	1,177,753	3%	77%	10,000,000	196,292,237
1957	60,000	1,118,993	3%	77%	10,000,000	186,498,915
1958	60,000	1,103,908	3%	77%	10,000,000	183,984,592
1959	60,000	1,017,066	3%	77%	10,000,000	169,511,041
1960	60,000	979,597	3%	77%	10,000,000	163,266,236
1961	60,000	946,872	3%	77%	10,000,000	157,812,041
1962	60,000	881,504	3%	77%	10,000,000	146,917,293
1963	60,000	835,530	3%	77%	10,000,000	139,254,940
1964	60,000	778,063	3%	77%	10,000,000	129,677,225
1965	60,000	717,363	3%	77%	10,000,000	119,560,562
1966	60,000	654,806	3%	77%	10,000,000	109,134,298
1967	60,000	618,829	3%	77%	10,000,000	103,138,196
1968	60,000	566,501	3%	77%	10,000,000	94,416,868
1969	60,000	525,205	3%	77%	10,000,000	87,534,107
1970	60,000	498,123	3%	77%	10,000,000	83,020,471
1971	60,000	458,376	3%	77%	10,000,000	76,395,948

Year	[illegible]				[illegible]	
	Statutory	1998 Wealth[1]	Initial Rate	Top Rate[2]	Statutory[3]	1998 Wealth[1]
1972	60,000	416,921	3%	77%	10,000,000	69,486,786
1973	60,000	373,106	3%	77%	10,000,000	62,184,290
1974	60,000	344,616	3%	77%	10,000,000	57,436,034
1975	60,000	316,360	3%	77%	10,000,000	52,726,604
1976	60,000	283,593	3%	77%	10,000,000	47,265,531
1977	120,000	509,010	18%	70%	5,000,000	21,208,742
1978	134,000	502,784	18%	70%	5,000,000	18,760,583
1979	147,000	494,173	18%	70%	5,000,000	16,808,602
1980	161,000	497,167	18%	70%	5,000,000	15,439,983
1981	175,000	482,872	18%	70%	5,000,000	13,796,335
1982	225,000	596,669	18%	65%	4,000,000	10,607,446
1983	275,000	672,739	18%	60%	3,500,000	8,562,128
1984	325,000	716,026	18%	55%	3,000,000	5,609,471
1985	400,000	822,599	18%	55%	3,000,000	6,169,493
1986	500,000	972,095	18%	55%	3,000,000	5,832,572
1987	600,000	1,099,367	18%	55%	3,000,000	5,496,835
1988	600,000	1,021,578	18%	55%	3,000,000	5,107,890
1989	600,000	948,491	18%	55%	3,000,000	4,742,457
1990	600,000	898,109	18%	55%	3,000,000	4,490,546
1991	600,000	871,864	18%	55%	3,000,000	4,359,322
1992	600,000	826,110	18%	55%	3,000,000	4,130,549
1993	600,000	786,594	18%	55%	3,000,000	3,932,968
1994	600,000	742,559	18%	55%	3,000,000	3,712,797
1995	600,000	709,607	18%	55%	3,000,000	3,548,036
1996	600,000	673,301	18%	55%	3,000,000	3,366,503
1997	600,000	636,003	18%	55%	3,000,000	3,180,017
1998	625,000	625,000	18%	55%	3,000,000	3,000,000
1999	650,000	613,205	18%	55%	3,000,000	2,830,175
2000	675,000	600,745	18%	55%	3,000,000	2,669,979
2001	675,000	566,742	18%	55%	3,000,000	2,518,853
2002	700,000	554,464	18%	55%	3,000,000	2,376,275
2003	700,000	523,077	18%	55%	3,000,000	2,241,761
2004	850,000	599,214	18%	55%	3,000,000	2,114,875
2005	950,000	631,800	18%	55%	3,000,000	1,995,158
2006	1,000,000	627,406	18%	55%	3,000,000	1,882,219

Table 4 (Continued)
Estate Tax Filing Requirements and Tax Rates, 1916-2006

[1] Adjusted for the change in wealth, as measured by gross domestic product, between 1916 through 1998. Nominal GDP is assumed to increase by 6 percent a year thereafter.

[2] Refers to the top rate on the supplemental estate tax in place from 1932 to 1953.

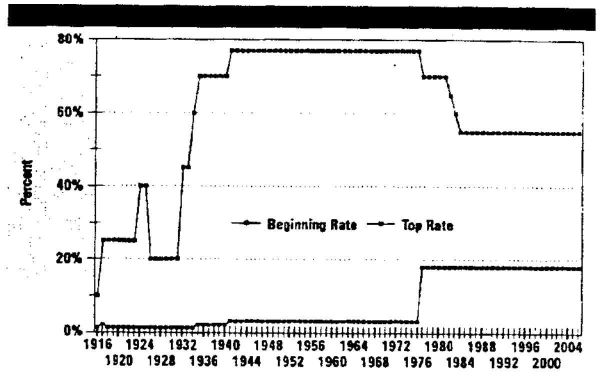
[3] Refers to the top bracket amount on the supplemental estate tax in place from 1932 to 1953.

Summary of U.S. Estate Taxation

Several main points emerge from the history of estate taxation in the United States:

- Until the 1920s, estate taxes were used as a sporadic, and temporary, way to finance wars. When hostilities ceased, the tax was repealed.
- From the 1920s through the 1940s, estate taxes became another weapon in the arsenal to redistribute income. Confiscatory tax rates of up to 77 percent on the largest estates were supposed to prevent wealth from becoming increasingly concentrated in the hands of a few. [See Figure 1 and Table 4 for the starting and top estate tax rates since 1916.]
- Loophole closing preoccupied tax reformers during the late 1960s and early 1970s. Their efforts culminated in a 1976 tax bill that overhauled estate taxation. Unification of estate and gift taxes, carryover basis rules and a new generation-skipping transfer tax were supposed to make it more difficult for people to avoid estate taxes.
- Lower income tax rates enacted in 1981 were extended to estate taxes and the exemption was increased to remove smaller estates from the tax rolls.

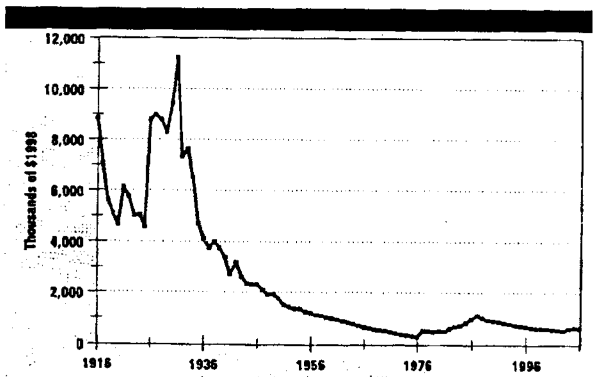
Figure 1
Estate Tax Rates, 1915–2006



Since then, estate taxes have been on the rise, this time a weapon in the arsenal to fight federal deficits. Time has seriously eroded the value of the estate tax exemption. In 1916, estates under $9 million (in today's dollars) would not have been taxed. Contrast that with the $600,000 exemption in place since 1987. As a result, increasing numbers of middle income Americans face the prospect of having their heirs presented with an estate tax bill. [See Figure 2 for the estate tax exemption in today's dollars since 1916.]

As has happened with the income tax, high marginal tax rates on estates have produced an extremely complex tax system as rules and regulations concerning what is and is not taxable or special dispensation for favored groups continually creep into the code.

Figure 2
Estate Tax Exemption, 1915–2006
Adjusted for Economic Growth



The Estate Tax Today

How exactly does the estate tax work today? Table 5 contains the tax schedule (rates and bracket amounts) that apply to the taxable estates of people who died in 1997. *Taxable estate* is gross estate less deductions. Nominally, tax rates start at 18 percent on taxable estates of less than $10,000 and rise to 55 percent on taxable estates over $3 million. In the thirteen years since this schedule was put in place, asset values have more than tripled. But, because bracket amounts are not indexed, more estates hit the top tax bracket today than did ten or fifteen years ago.

Table 5
Estate Tax Rates and Bracket Amounts, 1997

Taxable Estate		Base Tax	
Over	But Less Than	Rate	Amount
0	10,000	18%	0
10,000	20,000	20%	1,800
20,000	40,000	22%	3,800
40,000	60,000	24%	8,200
60,000	80,000	26%	13,000
80,000	100,000	28%	18,200
100,000	150,000	30%	23,800
150,000	250,000	32%	38,800
250,000	500,000	34%	70,800
500,000	750,000	37%	155,800
750,000	1,000,000	39%	248,300
1,000,000	1,250,000	41%	345,800
1,250,000	1,500,000	43%	448,300
1,500,000	2,000,000	45%	555,800
2,000,000	2,500,000	49%	780,800
2,500,000	3,000,000	53%	1,025,800
3,000,000	999,999,999	55%	1,290,800
Unified Credit[1]	192,800		
Exemption[2]	600,000		

[1] Same rate schedule has been in place since 1984. Changes in unified credit are as follows: $96,300 ($325,000) in 1984; $121,800 ($400,000) in 1985; $155,800 ($500,000) in 1986 and $192,800 ($600,000) since 1986. Equivalent exemption amounts shown in parentheses.

[2] Tax calculation for an estate of $600,000:

Base tax on $500,000	155,800
Plus	
Tax rate on estates between $500,000 and $750,000	0.37
Times	
600,000 minus 500,000	100,000
Equals	
Estate Tax	192,800

The unified credit of $192,800 translates into an exemption amount of $600,000. Here's how it works. Remember that the credit reduces taxes on gifts and estates. If the individual did not have occasion to use the credit for gifts in excess of $10,000 – as is the case for most people – the credit would offset up to $192,800 in estate tax liability. Reading from the tax schedule, a $500,000 estate would owe $155,800 in tax. Another $100,000 of estate would be taxed at a marginal rate of 37 percent, bringing the total tax on a $600,000 estate to $192,800. Although the tax schedule gives the impression that the estate tax starts at 18 percent, in fact, the unified credit means that most people will begin paying at a marginal rate of 37 percent on the first dollar of taxable estate.

"The unified credit means that most people will begin paying at a marginal rate of 37 percent on the first dollar of taxable estate."

Who Pays Estate Taxes?

In 1995, 69,722 estates exceeded the $600,000 exemption and were required to file an estate tax return. Over half (53.5%) of those returns reported the size of gross estate to be under $1 million and 96.3 percent were under $5 million. Although only 300 returns (0.4%) had estates worth over $20 million, they accounted for a much larger share (13.1%) of gross estate than those under $5 million (70.3%). [See Table 6 for estate tax returns filed in 1995 by size of gross estate.]

Table 6
Estate Tax Returns Filed in 1995: Gross Estate and Estate Tax by Size of Gross Estate

[1] Gross estate is shown at the value used to determine estate tax liability. The value could be determined as of date-of-death or six months thereafter (i.e., alternate valuation method).

Note: Detail may not add to totals because of rounding.

Source: Internal Revenue Service, *SOI Bulletin*, Publication 1136 (Rev. 2-97).

Size of gross estate	Gross estate tax purposes				Net estate tax	
	Number	% of total	Amount	% of total	Amount	% of total
All returns, total	**69,772**	**100.0%**	**117,735,156**	**100.0%**	**11,841,034**	**NA**
$600,000 under $1,000,000	37,329	53.5%	28,556,829	24.3%	651,160	NA
$1,000,000 under $2,500,000	24,558	35.2%	36,077,544	30.6%	2,999,760	NA
$2,500,000 under $5,000,000	5,331	7.6%	18,105,550	15.4%	2,748,165	NA
$5,000,000 under $10,000,000	1,683	2.4%	11,654,534	9.9%	2,053,433	NA
$10,000,000 under $20,000,000	571	0.8%	7,862,146	6.7%	1,384,768	NA
$20,000,000 or more	300	0.4%	15,478,551	13.1%	2,003,748	NA
Taxable returns, total	**31,564**	**100.0%**	**67,183,128**	**100.0%**	**11,841,034**	**100.0%**
$600,000 under $1,000,000	13,830	43.8%	11,195,554	16.7%	651,160	5.5%
$1,000,000 under $2,500,000	12,710	40.3%	18,845,531	28.1%	2,999,760	25.3%
$2,500,000 under $5,000,000	3,298	10.4%	11,288,768	16.8%	2,748,165	23.2%
$5,000,000 under $10,000,000	1,105	3.5%	7,769,030	11.6%	2,053,433	17.3%
$10,000,000 under $20,000,000	390	1.2%	5,366,395	8.0%	1,384,768	11.7%
$20,000,000 or more	231	0.7%	12,717,850	18.9%	2,003,748	16.9%
Nontaxable returns, total	**38,207**	**100.0%**	**50,552,028**	**100.0%**	**NA**	**NA**
$600,000 under $1,000,000	23,498	61.5%	17,361,275	34.3%	NA	NA
$1,000,000 under $2,500,000	11,849	31.0%	17,232,013	34.1%	NA	NA
$2,500,000 under $5,000,000	2,032	5.3%	6,818,782	13.5%	NA	NA
$5,000,000 under $10,000,000	578	1.5%	3,885,505	7.7%	NA	NA
$10,000,000 under $20,000,000	182	0.5%	2,495,751	4.9%	NA	NA
$20,000,000 or more	68	0.2%	2,760,702	5.5%	NA	NA

"While the U.S. population quintupled in the last fifty years, estate tax returns increased tenfold."

Less than half (45.2%) the estates filing returns owed tax. Over half (54 percent) of the $11.8 billion in tax was collected from estates valued at less than $5 million. Estates worth between $5 and $20 million paid 29 percent of the tax while those over $20 million paid 16.9 percent.

Changes between 1945 and 1995

"Smaller estates (under $2.5 million in 1995 dollars) make up a much larger share of total returns today than in 1945 (88.7% versus 33.4%)."

The distribution of estate tax returns looked different fifty years ago. Estates under $100,000 ($3.3 million in 1995 dollars), although generally exempt from tax, accounted for 43.6 percent of estate tax returns.[18] Estates between $100,000 and $500,000 ($16.3 million in 1995 dollars) accounted for 50.1 percent of returns. Estates over $500,000 made up the remaining 6.3 percent. [See Table 7 for estate tax returns filed in 1945 by size of gross estate.]

Of the 19,000 returns filed, 86.2 percent paid tax totalling $597,177 ($19 million in 1995 dollars). Almost all the tax (94%) was paid by estates over $150,000 ($4.9 million in 1995 dollars). The largest estates (over $1 million, or $32.6 million in 1995 dollars) paid about half (47.5%).

Table 7
Estate Tax Returns Filed in 1945: Gross Estate and Estate Tax, by Size of Gross Estate

[illegible]	[illegible]				[illegible]	
	Number	%	Amount	%	Amount	%
All returns, total	19,000	100.0%	3,934,976	100.0%	NA	NA
Under $100,000	8,276	43.6%	644,747	16.4%	NA	NA
$100,000 under $150,000	4,482	23.6%	543,532	13.8%	NA	NA
$150,000 under $250,000	3,067	16.1%	583,296	14.8%	NA	NA
$250,000 under $500,000	1,973	10.4%	668,175	17.0%	NA	NA
$500,000 under $1,000,000	780	4.1%	541,997	13.8%	NA	NA
$1,000,000 or more	422	2.2%	953,231	24.2%	NA	NA
Taxable returns, total	16,374	100.0%	NA	NA	597,177	100.0%
Under $100,000	6,192	37.8%	NA	NA	7,243	1.2%
$100,000 under $150,000	4,187	25.4%	NA	NA	28,496	4.8%
$150,000 under $250,000	2,931	17.9%	NA	NA	63,533	10.6%
$250,000 under $500,000	1,890	11.5%	NA	NA	105,769	17.7%
$500,000 under $1,000,000	761	4.6%	NA	NA	108,247	18.1%
$1,000,000 or more	413	2.5%	NA	NA	283,889	47.5%
Nontaxable returns, total	2,626	100.0%	NA	NA	NA	NA
Under $100,000	2,084	79.4%	NA	NA	NA	NA
$100,000 under $150,000	315	12.0%	NA	NA	NA	NA
$150,000 under $250,000	136	5.2%	NA	NA	NA	NA
$250,000 under $500,000	83	3.2%	NA	NA	NA	NA
$500,000 under $1,000,000	19	0.7%	NA	NA	NA	NA
$1,000,000 or more	9	0.3%	NA	NA	NA	NA

Source: Janet G. McCubbin, "The Intergenerational Wealth Study: Basic Estate Data, 1916-1945," Internal Revenue Service, *SOI Bulletin*, Spring 1990.

[1] Bracket amounts for 1945 translated into 1995 dollars using the change in GDP between those two years are as follows:

Nominal	$1995
100,000	3,256,989
150,000	4,885,484
250,000	8,142,473
500,000	16,284,946
1,000,000	32,569,892

While the U.S. population quintupled in the last fifty years, estate tax returns increased tenfold. As a result, smaller estates (under $2.5 million in 1995 dollars) make up a much larger share of total returns today than in 1945 (88.7% versus 33.4%). Because exemption levels have not kept up with asset values, more and more small estates must file returns. [See Table 8 for the change in estate tax returns between 1945 and 1995 and Figure 3 for a comparison between the growth in returns and population.]

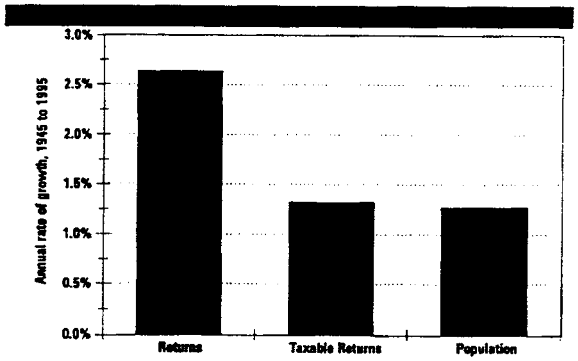


Figure 3
Estate Returns Grew Twice as Fast as Population, Taxable Returns the Same

Table 8
Change in Estate Tax Returns, 1945 to 1995

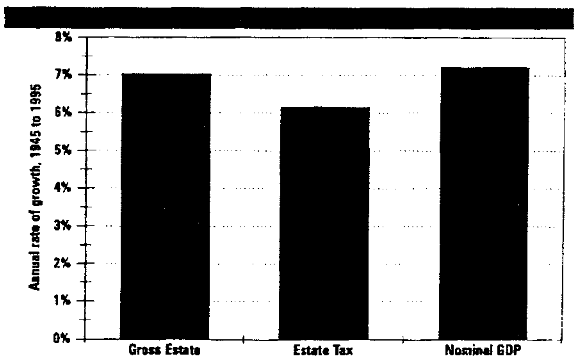
Basic data for 1945 come from Janet G. McCubbin, "The Intergenerational Wealth Study: Basic Estate Data, 1916-1945," Internal Revenue Service, *SOI Bulletin*, Spring 1990.

Basic data for 1995 come from Internal Revenue Service, *SOI Bulletin*, Publication 1136 (Rev. 2-97).

Size of gross estate ($1995)	1945 Number or Amount	1945 Distribution	1995 Number or Amount	1995 Distribution
Returns filing estate tax returns				
Under $2,500,000	6,352	33.4%	61,887	88.7%
$2,500,000 under $5,000,000	8,289	43.6%	5,331	7.6%
$5,000,000 under $10,000,000	2,395	12.6%	1,683	2.4%
$10,000,000 under $20,000,000	1,240	6.5%	571	0.8%
$20,000,000 or more	723	3.8%	300	0.4%
Total	19,000	100.00%	69,772	100.0%
Taxable Returns				
Under $2,500,000	4,753	29.0%	26,540	84.1%
$2,500,000 under $5,000,000	7,426	45.4%	3,298	10.4%
$5,000,000 under $10,000,000	2,292	14.0%	1,105	3.5%
$10,000,000 under $20,000,000	1,197	7.3%	390	1.2%
$20,000,000 or more	707	4.3%	231	0.7%
Total	16,374	100.0%	31,564	100.0%
Net Estate Tax (in thousands of nominal $)				
Under $2,500,000	5,560	0.9%	3,650,920	30.8%
$2,500,000 under $5,000,000	69,193	11.6%	2,748,165	23.2%
$5,000,000 under $10,000,000	89,469	15.0%	2,053,433	17.3%
$10,000,000 under $20,000,000	107,291	18.0%	1,384,768	11.7%
$20,000,000 or more	325,665	54.5%	2,003,748	16.9%
Total	597,177	100.0%	11,841,034	100.0%

Although more estates file returns today, the number which owe tax has not grown faster than the population. Although the total size of gross estate has kept pace with the economy, estate tax revenues have grown more slowly than GDP, due to a drop in the top tax rate from 77 percent in 1945 to 55 percent in 1995 and the rapid growth in estate tax planning. [See Figure 4 for comparison of growth in estate size, estate taxes and GDP.]

Figure 4
Gross Estate Grew as Fast as GDP, Estate Tax Somewhat Slower



In short, estate taxes are more likely to affect small to medium-sized estates today than fifty years ago. While the top tax rate is lower today, it hits much sooner, subjecting relatively small estates to high marginal rates.

How Estate Taxes Affect the Economy

People save for two reasons—either to consume in the future or make bequests. Estate and gift taxes hit the latter directly.

Lawrence Summers, now Deputy Secretary of the Treasury, has estimated that about half of all saving is directed toward bequests.[19] As shown earlier, estates today face marginal tax rates between 37 and 55 percent. Because of the huge part that bequests play in saving, these high estate tax rates discourage saving which, in turn, leads to less investment, slower economic growth and lower tax revenues.[20]

Why Estate Tax Rates Matter

Taxes affect growth by changing the aftertax returns to the factors of production – capital and labor. If taxes are cut, the aftertax return on the ***next dollar of invested capital*** goes up, and investors supply more capital. Similarly, if the aftertax wage rate on the ***next hour of work*** goes up, workers supply more labor. The reverse happens if taxes are raised. Because estate taxes are tied to asset values, they act primarily on capital, with higher tax rates raising the cost of capital and lower tax rates reducing the cost.

"Estate taxes are more likely to affect small to medium-sized estates today than fifty years ago."

Notice that the aftertax return refers to the next dollar invested or the next hour worked. Because economic decisions usually involve adjustments – up or down – from the status quo, or equilibrium, it is *marginal*, not average, tax rates that matter. Marginal tax rates that are higher than the average tend to dampen growth because the added return from investing another dollar or working another hour is lower than the average return. Put another way, for the economy to produce the most output at the lowest cost, average and marginal tax rates must equal each other.[21]

Marginal estate tax rates are much higher than average rates. On average, federal estate taxes currently take 8 cents for every $100 in the stock of U.S. capital. That is down from 17 cents in 1972 but up from 5 cents through much of the 1980s. Adding estate taxes at the state and local level raises the average tax rate to 11 cents. [See Figure 5 for average estate tax rates from 1954 to 1997.]

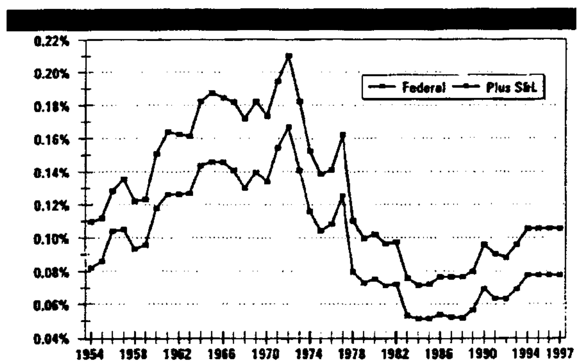
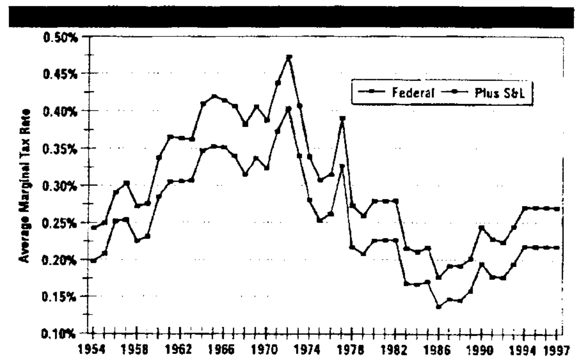


Figure 5
Average Estate Tax Rates, 1954–1997
On a $ of Economy-wide Capital

Figure 6
Marginal Estate Tax Rates, 1954–1997
On Next $ of Economy-wide Capital



However, federal estate taxes claim 22 cents out of an *additional* $100 in capital stock. While lower than the 40 cents in 1972, it is more than the 14 cents in 1986. Including state and local estate taxes raises the marginal tax rate to 27 cents. [See Figure 6 for marginal estate tax rates from 1954 to 1997.]

"All taxes are really income taxes that ultimately fall on the earnings of capital and labor."

Table 9 shows how estate tax rates affect capital. Suppose the initial price of an asset was $100. Assuming a 6 percent return, the asset should generate $6 in income each year. But, because federal estate taxes will claim 22 cents of the asset, its real cost is $100.22. Even though nominally levied on assets in the estate, the tax gets paid out of income generated by the assets. The same principle applies to property taxes, corporate taxes, sales taxes and so forth. Whatever the label, people pay taxes out of income they earn through work, saving or investing. In other words, all taxes are really income taxes that ultimately fall on the earnings of capital and labor.

Going back to the example, because the asset cost $100.22, not $100.00, its annual return is really only $5.99, not $6. Including state and local taxes raises the asset price to $100.27 and lowers the annual return to $5.98.

Table 9
How Estate Taxes Raise the Cost of Capital, Lower Its Return

Effect on Cost of Asset	
Initial asset price	$100.00
Estate Tax Rate	
Federal	0.22%
Plus State & Local	0.27%
Tax-inclusive cost of asset[1]	
Federal	$100.22
Plus State & Local	$100.27
Effect on Income from Asset	
Expected annual income	$6.00
Income aftertax estate tax[2]	
Federal	$5.99
Plus State & Local	$5.98

[1] Asset price times one plus estate tax rate.

[2] Annual income times one minus estate tax rate.

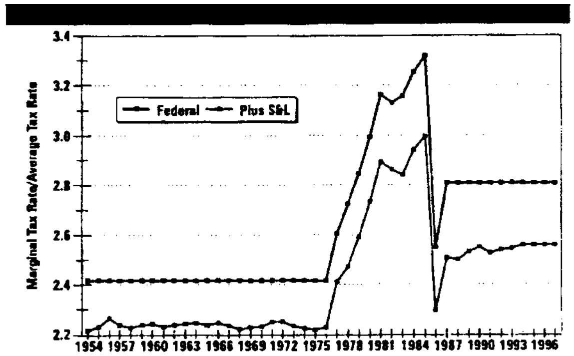


Figure 7
Marginal Estate Tax Rate is 2 to 3 Times Larger than the Average Rate

Economy-wide, the marginal federal estate tax rate is 2.8 times higher than the average rate while that for state and local governments is 1.9 times higher. Putting the two together, the marginal estate tax rate on U.S. capital is 2.6 times higher than the average rate. Because marginal estate tax rates are much higher than average rates, economic efficiency suffers. [See Figure 7 for the ratio of marginal to average estate tax rates from 1954 to 1997.]

"The largest estates do not pay the highest tax rates."

Medium-sized Estates Pay the Highest Tax Rates

An earlier section showed estate taxes are more likely to affect small and medium-sized estates today than fifty years ago. What is more, the largest estates do not pay the highest tax rates. In 1995, estates over $20 million paid an average tax rate of 12.5 percent. But the highest average rate – 17.4 percent – fell on estates between $5 and $10 million. Close behind, estates between $10 and $20 million paid an average rate of 17 percent. [See Table 10 and Figure 8 for average tax rates by size of estate.]

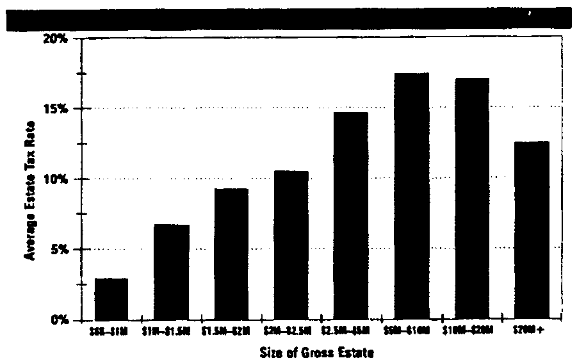


Figure 8
Medium Estates Pay Highest Tax Rates

Table 10
Average Estate Tax Rates for 1995

Estimated from Fiscal Associates Estate Tax Model. Based on all returns.

[illegible]	Gross Estate		[illegible] Tax After Credit [illegible]		
	Number of Returns	Average Amount	Number of Returns	Average Amount	Average Tax Rate
$100,000-$199,999	356,747	150,956	0	0	0.0%
$200,000-$299,999	153,793	250,950	0	0	0.0%
$300,000-$399,999	69,481	350,944	0	0	0.0%
$400,000-$499,999	34,298	450,953	0	0	0.0%
$500,000-$599,999	20,761	550,948	0	0	0.0%
$600,000-$699,999	13,526	649,614	2,219	2,838	0.4%
$700,000-$799,999	10,140	747,302	5,418	11,772	1.6%
$800,000-$899,999	7,438	846,242	3,386	25,526	3.0%
$900,000-$999,999	6,225	947,496	3,612	46,657	4.9%
$1,000,000-$1,249,999	8,895	1,118,787	4,263	68,208	6.1%
$1,250,000-$1,499,999	6,277	1,366,945	3,095	101,243	7.4%
$1,500,000-$1,749,999	3,888	1,610,206	2,075	132,371	8.2%
$1,750,000-$1,999,999	2,555	1,863,180	1,296	199,746	10.7%
$2,000,000-$2,249,999	1,714	2,110,025	925	226,713	10.7%
$2,250,000-$2,499,999	1,229	2,366,258	684	240,527	10.2%
$2,500,000-$4,999,999	5,330	3,396,914	3,350	497,469	14.6%
$5,000,000-$9,999,999	1,683	6,924,857	1,101	1,205,657	17.4%
$10,000,000-19,999,999	572	13,745,010	425	2,338,663	17.0%
$20,000,000 or more	299	51,767,732	234	6,464,009	12.5%

Who are most likely to have medium-sized estates that pay the highest tax rates? Typically they are owners of small businesses and family farms who amass wealth during their lifetimes through hard work and thrift. Because wealth is often unexpected, these people may not be aware of, or take full advantage of, ways to reduce estate taxes. As a result, those who come late, or not at all, to estate planning end up paying most of the tax. In contrast, the very rich, particularly those with inherited wealth, routinely plan ways to mitigate the death tax and pay lower estate tax rates.

All told, estate taxes are detrimental to the economy. Added to income taxes, estate taxes can bring the total tax rate on new investment to 100 percent.[22] Small businesses – which have fueled much of the current expansion – are hit particularly hard. Not only are they likely to pay the highest estate rates, heirs may have to sell some or all of the enterprise to pay the tax bill.[23]

What Estate Taxes Cost Society

Estate taxes discourage saving and investment, thereby damaging the economy. What would happen if federal estate taxes were eliminated? Answering that question requires two steps: (1) measuring the extent to which estate taxes raise taxes on capital, discouraging saving and investment and (2) estimating the macroeconomic effects on capital formation, employment and output if estate taxes were eliminated.

Addressing the first question requires a special estate tax model that includes the latest estate tax return data available from the Internal Revenue Service. Using this estate tax calculator, we estimate that eliminating the federal estate tax would reduce the average, economy-wide marginal tax rate on all U.S. capital by 0.25 percent. This lower tax on capital would raise the return to savers and investors. For example, doing away with estate taxes would initially raise the real, aftertax rate of return on corporate capital by almost

5 percent, inducing more saving and investment. This faster rate of capital formation would continue until the aftertax return is driven down to its long-run level.[24]

To assess the macroeconomic effects from eliminating the federal estate tax, we used our neoclassical, general equilibrium model of the U.S. economy.[25] Our results are expressed as changes from a *baseline*, that is, a forecast of how the economy would perform if there were no change in policy. At present our baseline, which is similar to those of the Congressional Budget Office and the Office of Management and Budget, projects the U.S. economy will grow at 2.5 percent a year after inflation over the next decade.

Eliminating the federal estate tax in 1999 would cause the economy to grow faster than in the baseline, mainly due to a more rapid expansion of the U.S. stock of capital. [See Table 11a for a summary of the economic effects expressed as a percent change from the baseline and Table 11b for differences from the baseline.] By the year 2010:

- Annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline.
- The stock of U.S. capital would be higher by almost $1.5 trillion, or 4.1 percent above the baseline.
- The economy would have created almost 236,000 more jobs than in the baseline.
- Between 1999 and 2008, the economy would have produced over $700 billion more in GDP than otherwise.

Table 11
Economic Effects from Eliminating the Estate Tax in 1999
Estimated using the Fiscal Associates Tax Model.

Year	Real GDP	Jobs	Stock of Capital	Real Growth
1999	0.39%	0.01%	2.31%	0.0002%
2000	0.41%	0.04%	2.72%	0.0002%
2001	0.39%	0.02%	2.99%	0.0002%
2002	0.50%	0.02%	3.30%	0.0003%
2003	0.56%	0.03%	3.55%	0.0003%
2004	0.66%	0.08%	3.68%	0.0003%
2005	0.75%	0.14%	3.82%	0.0004%
2006	0.81%	0.17%	3.94%	0.0004%
2007	0.82%	0.17%	4.02%	0.0004%
2008	0.86%	0.17%	4.07%	0.0004%

Year	GDP ($bil)	Jobs	Stock of Capital ($bil)
1999	34.0	15,144	562.6
2000	37.5	45,243	694.3
2001	37.5	23,002	796.9
2002	50.9	24,189	920.7
2003	59.4	39,789	1,034.7
2004	73.2	102,897	1,121.8
2005	87.6	179,214	1,219.5
2006	100.0	229,288	1,314.3
2007	106.4	229,911	1,404.8
2008	117.3	235,850	1,485.9
	Sum		Average
1999-2003	219.3	29,473	801.9
1999-2008	703.8	112,453	1,055.6

Boost to Growth Would Ultimately Benefit the Treasury

One major protest against eliminating the estate tax will undoubtedly be the loss of revenue to the federal Treasury. However, there are several reasons why this argument doesn't hold water.

First, estate taxes are a minor source of federal revenue. In 1995, the $11.8 billion in estate taxes amounted to less than one percent of federal revenues.[26]

Second, the estate tax imposes extremely high compliance costs – about as much as the tax raises.[27] In contrast, compliance costs associated with another tax nightmare, the alternative minimum tax (AMT) – amount to roughly a third of the AMT tax take.[28] Compliance costs are a deadweight loss to society because tax compliance adds nothing to output and diverts resources away from productive activities that do.

Third, the damage that estate taxes do to capital formation further magnifies the loss to society. Doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss. [See Table 12 for the static and dynamic revenue effects.]

- Between 1999 and 2008, eliminating the estate tax would cost the Treasury $191.5 billion.
- But the over $700 billion in additional GDP would yield $148.7 billion in higher income, payroll, excise and other federal taxes.
- In other words, higher growth would offset 78 percent of the static revenue loss over the first ten years.
- By 2006, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely.

Table 12
Static and Dynamic Revenue Effects from Eliminating the Estate Tax in 1999

Estimated using the Fiscal Associates Tax Model.

[1] Personal, corporate, payroll, excise tax revenue collected on added GDP shown in Table 11.

Year	Static Federal Tax Loss	Dynamic Federal Tax Gain[1]	Growth Offset of Static Loss	Net Effect on Federal Revenue	Net Effect on All Govt. Revenue
1999	-16.4	6.9	42%	-9.4	-1.8
2000	-16.9	8.9	53%	-7.9	2.3
2001	-18.1	8.0	44%	-10.2	0.9
2002	-18.7	10.5	56%	-8.2	5.1
2003	-20.1	18.4	92%	-1.6	15.1
2004	-19.0	14.8	78%	-4.3	12.9
2005	-18.9	17.6	93%	-1.3	18.0
2006	-19.7	20.0	102%	0.3	21.6
2007	-21.1	20.8	98%	-0.3	22.3
2008	-22.6	22.8	101%	0.2	24.5
1999-2003	-90.2	52.8	59%	-37.4	21.6
2004-2008	-101.3	95.9	95%	-5.4	99.4
1999-2008	-191.5	148.7	78%	-42.8	120.9

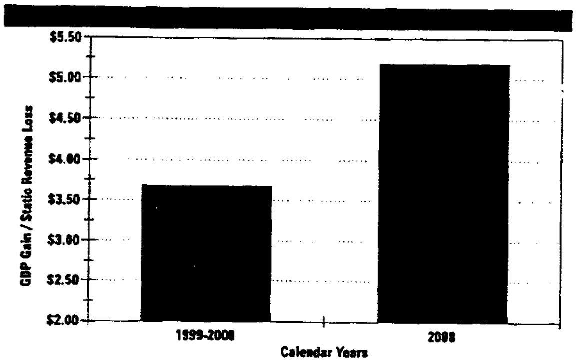


Figure 9
Eliminating the Estate Tax Would Prodxce Sizable Economic Gains

Bang for the Buck

Reducing estate taxes would generate sizable economic gains with little revenue loss. Over the next ten years, doing away with the estate tax would produce $3.67 in output for every dollar of static revenue loss. Longer run, the relative gains from the faster rate of capital formation would be even higher. In 2008, the ratio of GDP gain to static revenue loss would rise to $5.18. [See Figure 9.]

The high economic payoff makes reducing the estate tax an excellent candidate for a pro-growth tax cut. And elimination of the estate tax should be one element of any broad-based tax reform that aims to reduce the double taxation of saving and investment.

Conclusions

Once reserved for the rich, estate taxes are increasingly reaching into middle-class America over the last several decades. Much of the blame rests with tax policy that has not allowed the estate tax exemption to keep up with rising asset values.

While the estate tax purportedly aims to prevent wealth from becoming concentrated in the hands of a few, it is ironic that the largest estates do not pay the highest tax rates. That dubious honor falls on medium-sized estates, often belonging to people who have started and shepherded successful businesses. But, because they did not anticipate their success, they were unable to take advantage of estate planning.

Apart from fairness issues, estate taxation hurts the economy. Its sheer complexity results in high compliance costs – as much as estate taxes raise by one estimate. Compliance adds nothing to economic output while diverting resources from better uses.

Estate taxes have hit small businesses – which have fueled much of the economic expansion – particularly hard. Heirs sometimes must liquidate at least part of a successful enterprise just to pay the estate tax bill.

Because bequests are a primary motive behind saving, high marginal tax rates on estate assets raise capital costs and depress saving and investment. Because capital is so important to the economy, almost any move to reduce estate taxes should more than pay for itself through higher growth.

All in all, American taxpayers, the economy and government would be better off without estate taxes. Serious reduction or outright elimination of estate taxes might be one of the best legacies that the 106th Congress could leave future generations.

Endnotes

1 John R. Luckey, "A History of Federal Estate, Gift and Generation-skipping Taxes," Congressional Research Service, March 16, 1995

2 Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *SOI Bulletin*, Winter 1996-97.

3 Between 1869 and 1997, growth in nominal GDP has averaged about 5.6 percent a year. GDP for 1869 is from the U.S. Department of Commerce, *Historical Statistics of the United States, Colonial Times to 1970*, September 1975, Series F 1-5

4 Between 1860 and 1865, federal budget expenditures increased almost twenty-fold, from $63 million to $1.3 billion. Budget receipts quintupled from $56 million to $334 million. See *Historical Statistics of the United States*, Series Y 335-338.

5 Between 1866 and 1870, federal surpluses amounted to $348 million. See *Historical Statistics of the United States*, Series Y 335-338.

6 *Scholey v. Rew*, 23 Wall. (90 U.S.) 331 (1874).

7 *Pollack v. Farmers' Loan and Trust Company*, 158 U.S. 429 (1895).

8 Between 1898 and 1997, growth in nominal GDP has averaged about 6.6 percent a year. GDP for 1898 is from *Historical Statistics of the United States*, Series F 1-5 .

9 *Knowlton v. Moore*, 178 U.S. 41(900)

10 A return was required for gifts of property located in the U.S. made by individuals, corporations, associations, partnerships, trusts or estates, if total gifts exceeded the sum of authorized deductions for exemption, charitable gifts and previously taxed property, and if the total exceeded $500 to any one donee. *Historical Statistics of the United States, Part 2*, p. 1096.

11 *Bromley v. McCaughn*, 280 U.S. 124 (1929).

12 There were adjustments for appreciation before 1977, estate taxes paid on the property and state death taxes. Heirs also could increase the basis in all the decedent's property to a minimum of $60,000.

13 Estate taxes that would have applied if the first transfer had been ownership were owed in addition to those on the second transfer.

14 Previously, the marital exemption was limited to one-half the adjusted gross estate. When combined with the unified credit, estates of up to $425,625 could pass to the surviving spouse without tax.

15 If certain requirements were met, real estate used in the farm or business was valued at its present rather than "highest and best" use. This could reduce the size of gross estate by up to $500,000 provided that the decedent's family continued the farm or business for at least 15 years. Estate taxes attributable to the business also could be deferred for five years, except for interest, and paid over up to ten years thereafter.

16 Part of the appreciated value of the business could be considered a contribution of the surviving spouse and, therefore, not subject to estate taxes.

17 The phase-in was as follows: $47,000 ($175,625) in 1981; $62,800 ($225,000) in 1982; $79,300 ($275,000) in 1983; $96,300 ($325,000) in 1984; $121,800 ($400,000) in 1985; $155,800 ($500,000) in 1986 and $192,800 ($600,000) in 1987.

18 If the decedent had made gifts during his or her life, even estates below the exempt amount would have had to file a return.

19 Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*, Vol. 89, no. 4, 1981, pp. 706-732 and Laurence J. Kotlikoff and Lawrence H. Summers, "The Contribution of Intergenerational Transfers to Total Wealth: A Reply," in Modelling the Accumulation and Distribution of Wealth, eds. Denis Kessler and Andre Masson, Oxford England: Clarendon Press, 1988, pp. 53-56. Kotlikoff and Summers estimate that between 41 and 66 percent of current wealth is due to transfers from one generation to another, with an average of 53 percent.

20 For more on the relationship between saving and tax rates, see Gary and Aldona Robbins, *Eating Out Our Substance: How Taxation Affects Saving*, Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 131, August 1995.

21 Refers to any given level of taxation.

22 The top estate tax rate (55%) plus the top federal income tax rate (39.6%) equal 94.6 percent. Adding state and local income and estate taxes could easily bring the total rate to 100 percent or more.

23 While tax law provides for what is, in essence, a loan from the government, heirs still must give half of the business' value to the government.

24 The real aftertax rate of return to capital tends to remain around 3.5 percent. After a shock, such as a change in taxes on capital, we have found that historically it has taken about five years for 90 percent of the capital adjustment to occur that will bring the return back to its equilibrium value. For more see Aldona and Gary Robbins, *Eating Out Our Substance (II): How Taxation Affects Investment* , Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 134, November 1995.

25 The Fiscal Associates Model incorporates taxes through their effects on the returns to labor and capital. A tax cut that allows workers to keep more of the next dollar earned will increase the amount of labor they are willing to supply. Similarly, an increase in the aftertax return to capital, at the margin, will bring forth more saving and investment. Increases in the amount of capital and labor available to the economy will lead to more output, income and growth. For more on the Model see Gary and Aldona Robbins, *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, Lewisville, TX: Institute for Policy Innovation, Policy Report No. 138, July 1996.

26 The estate tax amount comes from Internal Revenue Service data for estate returns filed in 1995. According to budget documents, estate and gift taxes amounted to $14.8 billion out of a total $1,351 billion in federal revenues for fiscal 1995.

27 Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston, November/December 1988, pp. 3-28 and Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal*, vol 45, no. 2, Fall 1997, pp. 173-194.

28 Compliance costs for the alternative minimum tax amount to at least 30 percent of revenue collected. See Gary and Aldona Robbins, *Complicating the Federal Tax Code: A Look at the Alternative Minimum Tax (AMT)*, Institute for Policy Innovation, TaxAction Analysis, Policy Report No. 145, March 1998.

About the Authors

Gary Robbins is President of Fiscal Associates, an Arlington, VA economic consulting firm, and John M. Olin Senior Research Fellow of IPI. Mr. Robbins has developed a general equilibrium model of the U.S. economy that specifically incorporates the effects of taxes and government spending. He was Chief of the Applied Econometrics Staff at the U.S. Treasury Department from 1982 to 1985. He served as assistant to the Under Secretary for Tax and Economic Affairs from 1981 to 1982, and as Assistant to the Director of the Office of Tax Analysis from 1975 to 1981. Recent publications include IPI Policy Report #138: *Accounting for Growth: Incorporating Dynamic Analysis into Revenue Estimation*, and IPI Policy Report #140: *Tax Cuts: Who Wins? Who Loses.* Mr. Robbins' articles and analysis frequently appear in the financial press. He received his master's degree in Economics from Southern Methodist University.

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U.S. REPRESENTATIVE JIM SAXTON (R-NJ)
VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE

STATEMENT SUBMITTED TO THE
SUBCOMMITTEE ON TAX, FINANCE AND EXPORTS AND
SUBCOMMITTEE ON RURAL ENTERPRISES, BUSINESS OPPORTUNITIES AND SPECIAL SMALL BUSINESS PROBLEMS
COMMITTEE ON SMALL BUSINESS
U.S. HOUSE OF REPRESENTATIVES

MAY 13, 1999

Mr. Chairman and Members of the Committee: Thank you for inviting my testimony on the economic impact of the federal estate tax. As you may know, I have a long-standing interest in removing tax barriers to private saving. And what better place to start than the tax that ends it all – the estate tax?

The federal estate tax is one of the most confiscatory, anti-saving taxes now levied by the federal government. It is, by definition, a tax on accumulated savings. With marginal rates ranging from 37 percent up to 60 percent, it is easy to see how one-half of a dying couple's savings and accomplishments could end up going to Uncle Sam rather than to their children or grandchildren.

The estate tax received a brief flurry of attention last fall. At issue was Mark McGwire's record-breaking home-run ball. Recognizing that the value of that ball would instantly place the holder within reach of the federal estate tax, the IRS stepped forward – before the record-setting ball was even hit – to stake out its claim. According to news accounts, the IRS planned to use the estate and gift taxes to retrieve $150,000 from whomever caught the ball and tried to give it away.

Understandably, the IRS's action caused a great deal of consternation, leading even President Clinton's press secretary at the time, Mike McCurry, to proclaim: *"I thought that was about the dumbest thing I'd ever heard in my life. ... I'm sure that we probably would support* *anything that would keep nonsensical things from happening."* House Minority Leader Dick Gephardt observed: *"Only the IRS could turn a once-in-a-lifetime event into a once-in-a-lifetime Catch 22."*

I couldn't agree more. Yet these statements raise in my mind a more serious question. If taxing something as simple as an historic baseball constitutes *"nonsensical"* tax policy, how much more sense does it make to levy the same tax on a family that devoted decades of saving, sweat and sacrifice to build a successful family business, a business that creates jobs and pays income and payroll taxes? The answer, I suggest, is none.

Family businesses play an immensely important role in today's economy, contributing millions of jobs and billions of dollars in capital investments. In fact, the very concept of the "American Dream" is personified in the image of the successful family business, which enables a family to achieve upward income mobility and a higher standard of living. It is exactly for such reasons that it is disheartening to hear that 98 percent of heirs cited *"needed to raise funds to pay estate taxes"* when asked why family businesses fail.

My comments thus far have focused on the effect of the estate tax on family businesses. Yet there are other, equally important costs as well. Last December, I released a Joint Economic Committee study entitled *The Economics of the Estate Tax*, which offers a good review of these effects. (A copy of the study can be accessed at our website http://www.house.gov/jec/.) While the full range of costs identified in that study extend beyond my brief testimony, let me boil it down to a simple assessment: On balance, the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

A brief review of the study's findings illustrates the extensive costs and minimal benefits produced by the estate tax.

- First, the estate tax hurts economic growth by reducing the amount of capital available in the economy. The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.

- Second, the estate tax discourages saving and investment and encourages consumption. Indeed, at a time when there is so much attention being focused on retirement security, we as policymakers should support policies that encourage – not penalize – saving.

- Third, as already noted, the estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.

- Fourth, the estate tax obstructs environmental conservation. The need to pay large estate tax bills often forces families to develop environmentally sensitive land. Without the estate tax, landowners would have an easier time preserving natural habitats in a more environmentally sensitive manner.

- And finally, the estate tax imposes enormous compliance costs on taxpayers. According to one estimate, the costs of complying with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion. In other words, for every $1 the government allegedly raises in revenue, the economy actually loses $2 – one to pay the tax, and one in compliance costs.

In addition, a review of the arguments in favor of the estate tax suggests that the tax produces no benefits that would justify the large social and economic costs.

The most common rationale offered for the estate tax is to redistribute wealth. However, far from being a socially progressive tax, the estate tax is a "virtue tax" in the sense that it penalizes work, saving and thrift in favor of large-scale consumption. Contrary to conventional wisdom, there is no evidence that the estate tax is effective at reducing inequality. In fact, the tax may actually increase inequality of consumption.

Indeed, rather than promoting equality, the estate tax inhibits income mobility. According to one study, families at the bottom of the income distribution are more than twice as likely to move up the income ladder if they have self-employment income. By making it more difficult for family businesses to survive, the estate tax directly impedes the ability of families to achieve this upward income growth.

The second rationale for the estate tax is to raise revenue. A thorough analysis of the tax reveals that the estate tax raises very little, if any, net revenue for the federal government. Overall, the tax accounts for just over 1 percent of total federal revenue, or about $23 billion last year. Yet that figure greatly overstates the ability of the estate tax to raise revenue.

Perhaps more than any other tax, the highly confiscatory tax rates of the estate tax, often reaching 60 percent, alter people's behavior: they save and work less; they consume more; and they waste time and energy on tax avoidance activities. These distortionary effects result in revenue losses under the income tax that are roughly the same size as the estate tax revenue. Even Joseph Stiglitz, a former chairman of President Clinton's Council of Economic Advisers, has written that, *"Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime."*

Let me offer an analogy that helps highlight the counterproductive nature of the tax. Consider the situation you have with a factory that employs 100 workers. Income and payroll taxes consume a portion of what that factory and those workers produce. The estate tax consumes the factory itself. That's like killing (or rather, taxing to death) the goose that laid the golden egg.

In closing, I would like to frame the estate tax in its historical context. This Nation has imposed a federal estate tax on three separate occasions prior to its current manifestation. In each case, the tax was introduced to finance a short-term military action and was repealed within eight years. The initial pattern was similar in 1916, when the tax was implemented to help pay for World War I, but it unlike the previous three instances of the estate tax, this one was never repealed. In light of the highly negative impact that the estate tax has on the economy – in terms of capital accumulation, its bias against saving, and the burden on family businesses – I think it is time Congress consider returning to the practice of this Nation's Forefathers: In the absence of a national emergency, there is very little reason to retain the estate tax, and a host of reasons not to have it at all.

THE ECONOMICS OF THE ESTATE TAX

A JOINT ECONOMIC COMMITTEE STUDY

Jim Saxton (R-NJ), Chairman
and
Mac Thornberry (R-TX), Member

Joint Economic Committee
United States Congress

December 1998

Executive Summary

This analysis examines the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

- The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.
- The estate tax is a leading cause of dissolution for family-run businesses. Large estate tax bills divert resources from investment and employment and often force families to develop environmentally sensitive land.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality, and may actually increase inequality of consumption.
- The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.

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THE ECONOMICS OF THE ESTATE TAX

EXECUTIVE SUMMARY

This analysis examines the arguments for and against the federal estate tax and concludes that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce.

This paper documents the extensive costs associated with the federal estate tax. Specifically, the report finds:

- The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.
- The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging saving and investment and lowering the after-tax return on investments.
- The estate tax is extremely punitive, with marginal tax rates ranging from 37 percent to nearly 80 percent in some instances.
- The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.
- The estate tax obstructs environmental conservation. The need to pay large estate tax bills often forces families to develop environmentally sensitive land.
- The estate tax violates the basic principles of a good tax system: it is complicated, unfair and inefficient.

In addition, a review of the arguments in favor of the estate tax suggests that the tax produces no benefits that would justify the large social and economic costs.

- The estate tax is a "virtue tax" in the sense that it penalizes work, saving and thrift in favor of large-scale consumption.
- Empirical and theoretical research indicates that the estate tax is ineffective at reducing inequality, and may actually increase inequality of consumption.
- The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion in 1998.
- The deduction for charitable bequests stimulates little or no additional giving.
- The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.

THE ECONOMICS OF THE ESTATE TAX

I. INTRODUCTION

Benjamin Franklin noted over 200 years ago that "in this world nothing can be said to be certain, except death and taxes."[1] Unfortunately, the convergence of these two inescapable events, in the form of the federal estate tax, results in a number of destructive outcomes in terms of slower economic growth, reduced social mobility and wasted productive activity. Moreover, the costs imposed by the estate tax far outweigh any benefits that the tax might produce. The purpose of this paper is to review and analyze the theoretical and empirical foundations of the federal estate tax, and to explore the potential effects of eliminating or reducing estate taxation.

On the surface, some observers might believe that the present estate tax is free from serious controversy. For example, it is often claimed that the tax only falls on the "rich" and thus serves to reduce income inequality. Other supporters of the estate tax point to the $23 billion in tax revenue it raised in 1998, or to the incentives to leave bequests to charitable organizations. Such claims notwithstanding, there are many reasons to question why the government should tax the accumulated savings of productive citizens. Not the least of these reasons is the widely-held belief that families who work hard and accumulate savings should not be punished for such sound budgeting. Additionally, it is unclear whether the estate tax raises any revenue at all, since most if not all of its receipts are offset by losses under the income tax.

To preview the results of the present analysis, consider the conclusion drawn by Henry Aaron and Alicia Munnell, two prominent Democrat economists, in their study of the estate tax:

> In short, the estate and gift taxes in the United States have failed to achieve their intended purposes. They raise little revenue. They impose large excess burdens. They are unfair.[2]

The remainder of this paper is organized into four sections. Section II provides a brief overview of the history and mechanics of the estate tax. Section III reviews the arguments made in support of the estate tax, while Section IV addresses the tax's negative consequences. Section V concludes with a summary of the analysis and some general thoughts.

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[1] John Bartlett, *Familiar Quotations*, 16th ed. (Boston, MA: Little, Brown and Company, 1992), 310.

[2] The authors go on to prescribe ways to reform and improve the estate tax. Henry J. Aaron and Alicia H. Munnell, "Reassessing the Role for Wealth Transfer Taxes," *National Tax Journal* 45, no. 2 (June 1992): 138.

II. HISTORY AND MECHANICS OF THE FEDERAL ESTATE TAX[3]

The estate tax, also known as a death tax,[4] is simply a tax imposed on wealth transfers made at the holder's death. Death taxes have taken on several different forms in the United States, at both the state and the federal level. Three times in this nation's history, a federal death tax has been imposed only to be repealed shortly thereafter. In each instance, the estate tax was implemented to provide revenue on a short-term basis to finance military action.

The first federal death tax in this country was a death "stamp" tax established in 1797 to pay for a naval buildup in response to heightened tensions with France, and abolished just five years later in 1802. The federal death tax was absent the next 60 years, until Congress reenacted it in 1862 to raise revenue for the Civil War. After the war ended, Congress repealed the tax in 1870. The third federal death tax was enacted in 1898 to finance the Spanish-American War. As before, the estate tax was abolished after the war in 1902. With the advent of World War I, the estate tax was reintroduced in 1916 and has existed in various forms since.

The basic features of the current estate tax were adopted by the Tax Reform Act of 1976. This law established a unified system to tax all types of wealth transfers. The current estate tax thus consists of the traditional estate tax, plus two additional components designed to close "loopholes": a gift tax and a generation-skipping transfer (GST) tax. The gift tax requires that all taxable gifts made during life by the deceased be included when calculating the value of the estate. The GST tax captures wealth transfers that "skip" a generation, such as a trust that a grandmother leaves to her grandchildren. The value of all three types of wealth transfers are aggregated and taxed together at rates effectively ranging from 37 to 60 percent on net taxable estates. In certain instances involving GSTs, the combined marginal tax rate on estates can reach nearly 80 percent.[5]

Net taxable estate is defined as the gross value of estate assets and lifetime gifts, minus allowable deductions. The estate tax provides for many tax deductions. The most important of these is the unified credit which effectively exempts the first $625,000 of an estate from taxation. Other major provisions include an unlimited spousal deduction (so that transfers to spouses are not taxed), a deduction for bequests left to charitable organizations, and a credit for state death taxes. Other tax deductions are granted for specific situations, such as qualified family businesses or land set aside for environmental conservation.

Taxable gifts and GSTs are calculated separately before they are added to the aggregate estate. Donors are allowed to give $10,000 tax-free each year to any number of recipients.

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[3] This section draws heavily from John R. Luckey, "A History of Federal Estate, Gift, and Generation-Skipping Taxes," CRS Report for Congress 95-444 (Washington, DC: Congressional Research Service, 3/16/95).

[4] The term death tax refers to all forms of taxing wealth transfers between generations. Some systems impose a tax on wealth as it is received by the heirs (an inheritance or accessions tax), while other systems impose a tax as it leaves the possession of the decedent (an estate tax).

[5] Statutory rates range from 18 to 55 percent. The unified credit exempts from taxation estates below the 37 percent rate, and the phase-out of the unified credit for larger estates effectively raises the top marginal rate to 60 percent. Joint Committee on Taxation, Congress of the United States, *Present Law and Background Relating to Estate and Gift Taxes*, JCX-2-98 (Washington, DC: Joint Committee on Taxation, 1998), 2, 6, 15.

Thus, two parents together could give $20,000 annually to each of their children. Individuals are further granted a $1 million exemption for all generation-skipping transfers.

The Taxpayer Relief Act of 1997 sought to mitigate the impact of estate taxes by increasing available deductions.[6] The unified credit was raised from $600,000 per estate to its 1998 level of $625,000, and will gradually increase each year until it reaches $1 million in 2006. In addition, the Act indexed the deductions for gift and GST taxes for inflation beginning in 1998. Smaller provisions were also enacted to assist family-run businesses and land set aside for conservation.

III. ARGUMENTS FOR ESTATE TAXATION

Supporters of the estate tax generally rely on three different arguments. First, supporters claim the estate tax reduces inequality of wealth and income. Second, estate tax advocates contend that the deduction for charitable bequests encourages giving to nonprofit organizations. Finally, supporters argue that the $23 billion it raised in fiscal year 1998 warrants the estate tax's existence. The balance of this section considers each of these arguments in greater detail.

A. Inequality and the Distribution of Wealth

One of the most common arguments made in favor of the estate tax is that it reduces income and wealth inequality. Supporters of the estate tax contend that since the high tax rates apply only to the "rich," the effect should unambiguously reduce inequality. This assertion actually incorporates two interrelated assumptions: that high estate tax rates are theoretically justified in the context of a liberal, progressive philosophy; and that high estate tax rates do in fact reduce inequality.

This section demonstrates that both of these assumptions are flawed. First, the estate tax fails on liberal, progressive grounds because it discourages work and saving in favor of large-scale consumption. Second, there is no empirical evidence to support the view that the estate tax is effective at reducing inequality. In fact, much of the research which suggests that the estate tax is a poor tool to address inequality has been done by economists who themselves are generally sympathetic to issues of income inequality. Each of these arguments is examined in greater detail below.

The Liberal Philosophical Argument

The liberal philosophical argument against the estate tax is articulated by legal scholar Edward McCaffery, who identifies himself as an "an unrequited liberal ... whose views on social and distributive justice might best be described as progressive."[7] McCaffery argues that the estate tax fails even (or perhaps especially) from a liberal perspective.[8] Taxation of wealth

[6] Joint Committee on Taxation, Congress of the United States, *General Explanation of Tax Legislation Enacted in 1997*, JCS-23-97 (Washington, DC: Government Printing Office, 1997), 63-82.
[7] Edward J. McCaffery, "Rethinking the Estate Tax," *Tax Notes Today*, 6/22/95.
[8] McCaffery's published treatments of the estate tax include "The Uneasy Case for Wealth Transfer Taxation," *Yale Law Journal* 104, no. 2 (November 1994): 283-365; and "The Political Liberal Case against the Estate Tax," *Philosophy & Public Affairs* 23 (1994): 281-312.

transfers results in two general types of incentives: persons who want to leave inheritances can either avoid the tax through large *inter vivos* gifts and other tax loopholes; and they can reduce the size of their estate by consuming more of it or by work and saving less. McCaffery argues that both of these incentives contradict the basic values of work, saving and altruism which form the basis of the progressive liberal philosophy that McCaffery himself espouses.

On the first point, McCaffery argues that large *inter vivos* transfers, at best, "are not what the typical liberal political theorist seemed to have had in mind in supporting an estate tax."[9] At a minimum, parents who are induced to make large gifts early in their children's lives not only may reduce the labor supply of those children, but may also undermine whatever control they have over their children. Moreover, the porous nature of the current estate tax means that it will be ineffective at breaking up large concentrations of wealth and may in fact result in net revenue losses for the government. Efforts to tighten the estate tax by closing loopholes, however, would ultimately result in the even more detrimental outcome of reduced capital accumulation.

Second, and more importantly, McCaffery argues that estate taxation penalizes work and saving and encourages large-scale consumption by the very rich. If individuals know that they will be unable to pass on their wealth, then they may choose to simply produce less wealth or to consume their wealth. The accumulation of savings does not occur merely by accident or as a by-product of work. Rather, savings represent the conscious decisions of individuals to forgo immediate consumption.[10] The prospect of tax rates up to 60 percent, however, diminishes the value of their deferred consumption.

This incentive effect of the estate tax leads McCaffery to ask the question: what do liberals mean when they say they want greater equality? Is it equality of wealth or equality of consumption? According to McCaffery, the distinction between the two can be characterized as the difference between possession of wealth and use (i.e., consumption) of wealth. Ownership of wealth, McCaffery argues, is the preferred liberal outcome to consumption, since in the former case the wealth remains in the "common store of goods" where it produces a number of benefits through capital accumulation and its attendant outcomes.

McCaffery argues that in its basest form, the estate tax actually undermines the very concept of fairness and equality that the liberal progressive movement ought to support:

> The estate tax discourages behavior that a liberal, democratic society ought to like –work, savings, bequests – and encourages behavior that such a society ought to suspect – the large-scale consumption, leisure, and *inter vivos* giving of the very rich. Our polls and practices show that we like sin taxes, such as on alcohol and cigarettes. The estate tax is

[9] McCaffery, "The Political Liberal Case," 290.

[10] Venti and Wise present evidence showing that individuals who retire with a significant amount wealth made conscious decisions to save rather than consume their excess earnings. Carroll shows how increased estate taxes can lead individuals to reduce their bequest by increasing their consumption. Stephen F. Venti and David A. Wise, "The Cause of Wealth Dispersion at Retirement: Choice or Chance?" *American Economic Review* 88, no. 2 (May 1998): 185-191; and Christopher D. Carroll, "Why Do the Rich Save So Much?" Working Paper No. 98-12, Office of Tax Policy Research, University of Michigan, (December 1997).

an anti-sin, or a virtue, tax. It is a tax on work and savings without consumption, on thrift, on long-term savings. There is no reason even a liberal populace need support it.[11]

Empirical Evidence

A large body of empirical research has been produced which confirms the belief that inheritance either is not a major source of inequality, or that government policies aimed at inheritance are likely to be ineffective. There are three reasons for such conclusions. First, there is only a weak correlation between wealth and income. Thus, the elimination or curtailment of wealth transfers can have only a limited impact on the distribution of earnings. Second, efforts to curtail wealth transfers will induce wealth holders to increase their consumption, thereby increasing the inequality of consumption. Finally, the high degree of wealth and income mobility in the economy means that government efforts to redistribute wealth will necessarily meet with limited success. The remainder of this section will review the various empirical studies on the relationship between inheritance and inequality.

One of the more compelling arguments on the inequality aspect of estate taxation was prepared by Alan Blinder, a former member of the Federal Reserve Board appointed by President Clinton. In his book, *Toward an Economic Theory of Income Distribution*, Blinder attempted to decompose income inequality into its root causes, the results of which could then be used to identify policies that would be effective at reducing inequality. One finding of Blinder's analysis was that only about 2 percent of inequality was attributable to the unequal distribution of inherited wealth, leading him to conclude that "a radical reform of inheritance policies can accomplish comparatively little income redistribution."[12]

Subsequent research by Blinder attempted to explore in greater detail the role of estate taxation in reducing inequality. To account for the multi-generational nature of inheritance, Blinder developed an economic model that looked at families over a period of successive generations. Blinder then used the model to see what would happen to income inequality with different levels of estate taxation. Contrary to conventional wisdom, Blinder found that

> [E]state taxation is not a very powerful weapon in the egalitarian arsenal. A doubling of the tax rate, which must be considered as barely (if at all) within the realm of political feasibility, reduces both the average level and inequality of inherited wealth – but by very modest amounts. Even the ridiculous 60% [average] tax rate has effects which are far from revolutionary. The reformer eyeing the estate tax as a means to reduce inequality had best look elsewhere.[13]

Another critical analysis of the estate tax was prepared by Joseph Stiglitz, who served as Chairman of President Clinton's Council of Economic Advisers. In a 1978 article in the *Journal*

[11] McCaffery, "Rethinking the Estate Tax."
[12] Blinder uses the Gini ratio as the measurement of inequality. Alan S. Blinder, *Toward an Economic Theory of Income Distribution* (Cambridge, MA: MIT Press, 1974), 123, 137-139.
[13] By comparison, the average tax rate in 1995 was less than 18 percent. Alan S. Blinder, "Inequality and Mobility in the Distribution of Wealth," *Kyklos* 29 (1976): 618-9;-and Martha Britton Eller, "Federal Taxation of Wealth Transfers, 1992-1995," *Statistics of Income Bulletin* 16, no. 3 (Winter 1996-1997): 42-46.

of Political Economy, Stiglitz argued that it was wrong to look at the distributional aspects of estate taxation without considering the long-term impact on capital accumulation. Using such an approach, Stiglitz found that the estate tax may ultimately cause an *increase* in income inequality.[14] Even if the government acts to offset these capital accumulation effects, Stiglitz argued that the "desirability of the estate tax may still be questioned, not only because of the distortions which it introduces but also because it may actually increase inequality in the distribution of consumption."[15]

In other research, Stiglitz argues more explicitly that inheritances actually *decrease* inequality. In a 1979 article, Stiglitz (writing with David Bevan) asserted that because inheritances are used to redistribute income within family units, they may decrease inequality in lifetime consumption.[16] In yet another analysis, Stiglitz concluded that "it would seem clear that inheritances are unambiguously equality increasing" in terms of consumption, and an argument can be made that inheritances reduce inequality of income and wealth as well.[17]

The conclusions reached by Blinder and Stiglitz have been replicated by numerous other researchers. For example, a 1982 article by economist James Davies reported that "inheritance has a small impact on inequality in annual income and lifetime resources."[18] Mark Hugget's 1996 analysis found that differences in annual earnings are more important in accounting for inequality than differences in inheritance.[19] Similarly, a review of the historical evidence by G. P. Verbit found that that the estate tax had virtually no impact on the distribution on wealth over the previous five decades.[20] Indeed, the measurable effect of the estate tax on inequality is so small that neither the Congressional Budget Office nor the Treasury Department's Office of Tax Analysis even includes the estate tax in their standard analyses of the distribution of the tax burden.[21]

To some observers, it may appear counterintuitive that the estate tax, which is mainly levied on the wealthy, is ineffective at reducing inequality. One explanation for this finding is the high degree of wealth and income mobility present in the American economy. Far from being a static economy where wealth is permanently locked in the hands of a few families, the American

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[14] According to Stiglitz, the estate tax may increase the share of output attributable to capital, and since "income from capital is more unequally distributed than is labor income, the increase in the proportion of income accruing to capital may increase the total inequality of income." Joseph E. Stiglitz, "Notes on Estate Taxes, Redistribution, and the Concept of Balanced Growth Path Incidence," *Journal of Political Economy* 86, no. 2 (1978): S137-S150.

[15] *Ibid.*, S157.

[16] David L. Bevan and Joseph E. Stiglitz, "Intergenerational Transfers and Inequality," *Greek Economic Review* 1, no. 1 (August 1979): 13.

[17] Joseph E. Stiglitz, "Equality, Taxation and Inheritance," in *Personal Income Distribution: Proceedings of a Conference Held by the International Economic Association, Noordwijk aan Zee, Netherlands, April 18-23, 1977*, eds. Wilhelm Krelle and Anthony F. Shorrocks (New York, NY: North-Holland Publishing Company, 1978), 283.

[18] James B. Davies, "The Relative Importance of Inheritance and Other Factors on Economic Inequality," *Quarterly Journal of Economics* 97 no. 3 (1982): 495.

[19] Mark Hugget, "Wealth Distribution in Life-Cycle Economies," *Journal of Monetary Economics* 38, no. 3 (December 1996): 489-490.

[20] G. P. Verbit, "Do Estate and Gift Taxes Affect Wealth Distribution?" *Trusts & Estates* 117, no. 10 (October 1978): 598-616.

[21] Thomas A. Barthold, James R. Nunns, and Eric Toder, "A Comparison of Distribution Methodologies," in *Distributional Analysis of Tax Policy*, ed. David F. Bradford (Washington, DC: AEI Press, 1995), 107.

economy is best characterized as fluid and dynamic, where new wealth is constantly created and old wealth is naturally dispersed though intergenerational transfers.

The high degree of wealth mobility in America was noted as long ago as 1835 by Alexis de Tocqueville. De Tocqueville observed that in contrast to Europe where laws of primogeniture perpetuated family wealth, American wealth naturally dispersed over time:[22]

> The English laws concerning the transmission of property were abolished in almost all the states at the time of the [American] Revolution. The law [concerning inheritance] was so modified as not materially to interrupt the free circulation of property. The first generation having passed away, estates began to be parceled out; and the change became more and more rapid with the progress of time. And now, after a lapse of a little more than sixty years, the aspect of society is totally altered; the families of the great landed proprietors are almost all commingled with the general mass. In the state of New York, which formerly contained many of these, there are but two who still keep their heads above the stream; and they must shortly disappear. The sons of these opulent citizens have become merchants, lawyers, or physicians. Most of them have lapsed into obscurity. The last trace of hereditary ranks and distinctions is destroyed; the law of partition has reduced all to one level.
>
> I do not mean that there is any lack of wealthy individuals in the United States; I know of no country, indeed, where the love of money has taken stronger hold on the affections of men and where a profounder contempt is expressed for the theory of the permanent equality of property. But **wealth circulates with inconceivable rapidity, and experience shows that it is rare to find two succeeding generations in the full enjoyment of it.**[23] *(emphasis added)*

More recently, wealth mobility was the focus of a 1997 study by Nancy Jianakoplos and Paul Menchik. Jianakoplos and Menchik found that between 1966 and 1981, more than half of all households changed wealth quintiles. Their analysis of why households moved up or down the wealth distribution is revealing. Importantly, they found that receiving an inheritance helped families become upwardly mobile. Inheritance was particularly important in allowing households to enter the top decile of wealth. These findings suggest that inheritance is an important mechanism by which households in the bottom or middle of the wealth distribution are able to achieve upward mobility.[24] Similarly, the authors' analysis indicates that many households move down the wealth distribution due to a variety of factors, such as a change in

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[22] The laws of primogeniture were a feature of feudalism specifically intended to prevent the dispersion of wealth (which in ancient and medieval times meant land). It was felt that allowing landowners to freely distribute their estates (which presumably would have resulted in the division of the estate among several descendents) would destabilize the feudal order. In fact, that is exactly what happened when such laws were done away with in the United States. See, James Kent, *Commentaries on American Law, Vol. IV*, ed. O. W. Homes, Jr., 12th ed. (1873; reprint, Littleton, CO: Fred B. Rothman & Co., 1989), 377-390, 412.

[23] Alexis de Tocqueville, *Democracy in America – Volume I* (1835; reprint, New York, NY: Vintage Books, 1945), 53.

[24] See also the discussion on estate taxes and entrepreneurship accompanying *infra* notes 106 through 124.

marital status. Overall, Menchik and Jianakoplos concluded that the data supported the "idea that many of the very wealthy are products of 'self-made fortunes.'"[25]

Other data confirm this conclusion. A study of wealthy investors by Prince & Associates found that just 7 percent of respondents identified inheritance as the source of their wealth. The vast majority – 83 percent – earned their fortune through hard work, a family business, a professional practice such as law or medicine, or corporate employment.[26] In their book *The Millionaire Next Door*, authors Thomas Stanley and William Danko report that 81 percent of millionaires are first-generation rich, and just 14 percent of millionaires cite inheritance as the source of their wealth.[27] Most millionaires did not receive one dime of inheritance, and the vast majority (80 percent) received less than 10 percent of their wealth through inheritance.

The fact that just four out of five millionaires are first generation rich raises the question: if inheritance is not the source of their wealth, how did these did these individuals become millionaires? Stanley and Danko's survey indicates that the primary mechanism of achieving wealth is for families to manage their money effectively and lead a frugal lifestyle. Contrary to conventional wisdom, most millionaires do not lead high-priced lifestyles. For example, the typical millionaire has never spent more than $400 on a suit and paid just $24,800 for his current automobile. Aside from Visa and MasterCard, the two most common credit cards held by millionaires are Sears and J.C. Penny's.

In the context of Stanley and Danko's findings, it is perhaps not surprising that public support for confiscatory estate taxation is not very strong. A survey of public opinion polls about wealth and income reveals that most Americans continue to view and support the concept of America as a land of opportunity. Overwhelming majorities of Americans believe that hard work allows anyone to get ahead. In fact, close to 90 percent of Americans admire people who get rich though hard work.[28] Most Americans (56 percent) believe that wealth accumulation is permissible (Table 1).[29] Even at the lowest income levels, a majority of Americans continue to support the opportunity to accumulate wealth.

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[25] Nancy A. Jianakoplos and Paul L. Menchik, "Wealth Mobility," *Review of Economics and Statistics* 79, no. 1 (February 1997): 26.
[26] Ten percent cited real estate or other investments as their source of wealth. "Majority of Rich Investors Made Fortunes through Hard Work According to Private Asset Management Study," *Business Wire*, 6/14/94.
[27] Thomas J. Stanley and William D. Danko, *The Millionaire Next Door: The Surprising Secrets of America's Wealthy* (Atlanta, GA: Longstreet Press, 1996), 16, 32.
[28] 1997 survey by Pew Research Center, as reported in Everett Carll Ladd and Karlyn H. Bowman, *Attitudes toward Economic Inequality* (Washington, DC: AEI Press, 1998), 53.
[29] 1993 survey by the National Opinion Research Center, as reported in Ladd and Bowman, 109.

Table 1. Attitudes toward Wealth Accumulation

	"People should be allowed to accumulate as much wealth as they can even if some make millions while others live in poverty."		
	Strongly Agree or Agree	**Neither Agree nor Disagree**	**Strongly Disagree or Disagree**
Total	56%	11%	30%
Income level			
Under $15,000	51%	12%	33%
$15,000 to $19,999	59%	7%	33%
$20,000 to $29,999	54%	11%	34%
$30,000 to $49,999	60%	11%	27%
$50,000 to $74,999	60%	10%	27%
$75,000 and up	65%	12%	22%

Source: Ladd and Bowman.

Public attitudes toward death taxes are also reflected in legislation enacted at the state level. The will of the voters was directly expressed in a 1982 California referendum, when taxpayers voted by almost a two to one margin (64 percent to 36 percent) to eliminate the state's gift and inheritance taxes.[30] More recently, five states – New York, Louisiana, Kansas, Delaware, and Iowa – have enacted legislation since 1997 that will either eliminate or significantly reduce the burden of their state death taxes.[31]

Indeed, the story of "from rags to riches" is a familiar item in the American lexicon.[32] Proof of the dynamic nature of the American economy is evident in the *Forbes* annual list of the richest 400 Americans. Of the 400 persons who were on the first list in 1982, the vast majority – 74 percent – had completely dropped off the list 15 years later.[33] In the 1997 edition, self-made fortunes outnumbered inherited wealth by two to one.[34] Moreover, among the 10 wealthiest Americans, only three were even on the list of 400 back in 1982, and only one "old-time" family fortune made it into the top 10 (two heirs of Sam Walton were ranked ninth and tenth).[35]

In addition to the creation of "new" wealth, much wealth naturally dissipates over time through bequests and *inter vivos* gifts. Intergenerational transfers are by definition equality enhancing. For example, if a parent divides her estate evenly between her two children, then the concentration of wealth is reduced by one-half, and any wealth remaining after the second

[30] *U.P.I.*, 2/7/83.

[31] In recent years, many states have shifted to a "pick up" estate tax. Pick-up taxes impose a state estate tax equal to the tax credit available under the federal estate tax. Thus, states can still raise revenue from their estate tax, but the federal credit ensures that no additional tax liability is imposed on the taxpayer. *State Tax Notes* from 2/6/97, 7/31/97, 8/12/97, 4/29/98, and 8/19/98.

[32] For some examples of self-made fortunes, see "Rags to Riches," *Inc.*, 8/97; and Paul Craig Roberts op-ed, "Building Fortunes the American Way," *The Washington Times*, 12/5/97.

[33] "When Billionaires Become a Dime a Dozen," *Forbes*, 10/13/97.

[34] "Richest List Has Gates at No. 1, Plus 83 Californians," *The Los Angeles Times*, 9/29/97.

[35] "The Forbes 400," *Forbes*, 10/13/97; and "The Forbes 400," *Forbes*, 9/13/82.

generation must then be distributed among the presumably larger pool of third generation heirs.[36] The effect of intergenerational transfers on inequality may be even larger if, as some evidence indicates, parents tend to give more to their less well-off children.[37] Because concentrations of wealth are broken up through such mechanisms, many families who move "from rags to riches" may find themselves "back to rags again" after just a few generations.

B. Charitable Contributions

One objection to a reduction in the estate tax is that it would reduce contributions to charitable organizations. Because the estate tax allows individuals to deduct gifts to charitable organizations, there is a significant tax incentive to donate money at one's death. Reducing the tax on estates, the argument goes, could cause people to donate less money to charity. Recent research on this subject, however, indicates that the charitable tax deduction exerts only a modest, if any, stimulative effect. Although the charitable deduction affects the timing of donations, it may not significantly alter the overall level of giving.

According to tax return data, charitable organizations (excluding most churches) held assets valued at nearly $1.2 trillion in 1994. Gross revenues for these organizations totaled $619 billion, about one-fifth of which came from donations.[38] Tax-deductible charitable bequests in 1994 amounted to $9.3 billion, or 1.5 percent of the total revenue of charitable groups.[39] The large majority of non-profit organizations received nothing from charitable bequests in 1992, with only one-third of such groups reporting income from legacies or bequests.[40]

The Deduction for Charitable Bequests

The argument that the tax deductibility of charitable bequests encourages such donations is based on the "price" effect of lower taxes. For example, an estate with $100 at the 60 percent marginal tax rate faces a tax liability of $60. If this individual donates $40 to charity, the tax liability drops by $24 ($40 x 60%). Thus, every $1 this person gives to charity really only costs 40 cents, because 60 cents are saved in taxes. Since basic economic theory predicts that when the price of something decreases there is an increase in the amount purchased, an analysis of the price effect in isolation suggests that lowering tax rates would reduce charitable giving.

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[36] Stanley and Danko observe that the receipt of inheritance and *inter vivos* gifts may stimulate consumption and depress savings for some recipients. In such situations, little if any inheritance may be left for transmission to third and succeeding generations. See Stanley and Danko, 141-170.

[37] Cox and Raines report that transfers reduce income inequality among recipients, and McGarry and Schoeni show that parents tend to focus their financial assistance on their children with lower incomes. Donald Cox and Fredric Raines, "Interfamily Transfers and Income Redistribution," in *Horizontal Equity, Uncertainty, and Economic Well-Being*, eds. Martin David and Timothy Smeeding (Chicago, IL: University of Chicago Press, 1985), 403; and Kathleen McGarry and Robert F. Schoeni, "Transfer Behavior in the Health and Retirement Study – Measurement and the Redistribution of Resources within the Family," *Journal of Human Resources* 30 (supplement 1995): S184.

[38] Figure includes 501c(3) non-profit organizations, private foundations and charitable trusts. Paul Arnsberger, "Private Foundations and Charitable Trusts, 1994," *Statistics of Income Bulletin* 17, no. 2 (Fall 1997): 173-194; and Cecelia Hilgert, "Charities and Other Tax-Exempt Organizations, 1994," *Statistics of Income Bulletin* 17, no. 4 (Spring 1998): 89-110.

[39] Eller, 39.

[40] Figure excludes religious congregations. Virginia A. Hodgkinson, Murray S. Weitzman, Stephen M. Noga, and Heather A. Gorski, *A Portrait of the Independent Sector* (Washington, DC: Independent Sector, 1993), 67.

This example greatly oversimplifies the actual set of tax incentives faced by potential donors. Because charitable donations are also deductible for income tax purposes, the tax system as a whole is much friendlier to gifts during life than to gifts made at death. Using the example in the previous paragraph, if the same $40 gift were made during life, then the giver would save close to $16 on income taxes ($40 x 39.6%) in addition to the $24 savings on estate taxes (assuming top marginal tax rates).

Despite the substantial tax benefits, a casual review of the data provides little support for the contention that tax incentives greatly affect charitable bequests. According to IRS data, relatively few estates even make charitable bequests, and fewer still account for most of the dollars given. Over 1992-1995, more than four out of five estates (82 percent) did *not* take advantage of the charitable deduction. Although that proportion increases with the value of the estate, even among estates worth at least $20 million, almost one-half (49 percent) do not claim any such deduction. To a certain degree, even these numbers overstate the scope of charitable giving, as a very small number of estates account for the vast majority of dollars donated to charity. The last four years of tax return data (1992-1995) indicate that the wealthiest 0.3 percent of decedents accounted for 81 percent of all charitable bequests made during that period. In fact, a mere 0.006 percent of decedents (555 estate tax returns out of 8.6 million deaths) accounted for close to 39 percent of all charitable bequests.[41]

The last major reduction in estate taxes occurred in the 1981 Economic Recovery Tax Act (ERTA), which lowered the top statutory marginal rate from 70 percent for 1981 decedents to 55 percent for 1984 and subsequent decedents. In the five years prior to the reduction in the estate tax (1977-1981), total charitable bequests in the U.S. amounted to $31.9 billion.[42] After the rate cuts, total charitable bequests increased in real terms by nearly 23 percent, to $39.1 billion over the following five years (1982-1986). Charitable bequests as a share of GDP increased as well, rising from 0.105 percent to 0.123 percent.

Empirical Research on the Charitable Deduction

Despite the best efforts of econometric models, it remains extremely difficult to estimate the precise effect of tax incentives on charitable giving. The large number of factors that affect individual decisions hampers researchers' efforts to isolate and quantify the impact of one single consideration.[43] Although a number of studies have attempted to quantify the relationship between tax rates and charitable deductions, the conclusions have been varied. Some studies

[41] Calculations based on data from AAFRC Trust for Philanthropy, *Giving USA 1997* (New York, NY: AAFRC Trust for Philanthropy, 1996), 198; Eller; and U.S. Bureau of the Census, *Statistical Abstract of the United States 1997* (Washington, DC: Government Printing Office, 1997), 74.
[42] Dollar amounts in inflation-adjusted 1996 dollars. AAFRC Trust for Philanthropy, 198-199, 205.
[43] For example, recent research suggests that government spending itself depresses private donations. A. Abigail Payne, "Does the Government Crowd-Out Private Donations? New Evidence from a Sample of Non-Profit Firms," *Journal of Public Economics* 69, no. 3 (September 1998): 323-345. See generally, Barry W. Johnson and Jeffrey P. Rosenfeld, "Examining the Factors that Affect Charitable Giving," *Trusts & Estates* 130, no. 8 (August 1991): 29-37.

indicate that tax rates are quite important,[44] while other research demonstrates that tax rates play little, if any, role in encouraging charitable giving.[45] Unfortunately, a number of data and methodological problems inherent to charitable bequest models limit the usefulness of specific econometric estimates.[46]

One of the most revealing studies on this subject matched estate tax returns to the income tax returns of the same decedents in the years prior to death. The analysis, prepared by Eugene Steuerle of the Urban Institute, thus allows for examination of the giving patterns of the wealthy both during life and at death.[47] Steuerle's data indicate that individuals who gave generously during their life gave little at death, while those who gave little during life tended to give much more at death. For example, close to one-half (49 percent) of estates making charitable bequests of $250,000 or more reported less than $1,000 in itemized charitable donations on their income tax returns prior to death. This finding suggests that the tax incentives to give may not be strong enough to alter the combined level of giving during life and at death.

One explanation that Steuerle offers for this weak link is the form in which the wealthy hold their assets. Much of their wealth comes in a form that is not immediately affected by the income tax, such as the appreciated value of stock or real estate. Tax incentives, however, only work when income is realized and subject to taxation. Steuerle concluded that,

> [S]ince recognition of capital income at the individual level is largely a discretionary event, tax incentives to give will only apply to that income for which such discretion is exercised. For income that is not recognized or is sheltered by artificial losses, the price effect is basically zero. For many taxpayers, therefore, **the existing tax system may discourage the recognition of income so much that a charitable incentive applies only to a small portion of the true economic income of the taxpayer.** ...
>
> In effect, taxes can induce individuals to give only to the extent that their income is taxable. Given the fact that many of the very wealthy realize only a small part of their capital income, there is only a limited income tax incentive for them to donate significant portions of their wealth to charity during their lifetimes.[48] *(emphasis added)*

In brief, then, Steuerle's research suggests that tax incentives may play a relatively limited role in determining total lifetime giving. Some individuals choose to give during life in order to take advantage of the tax benefits in the income and estate taxes. Other individuals choose, for a

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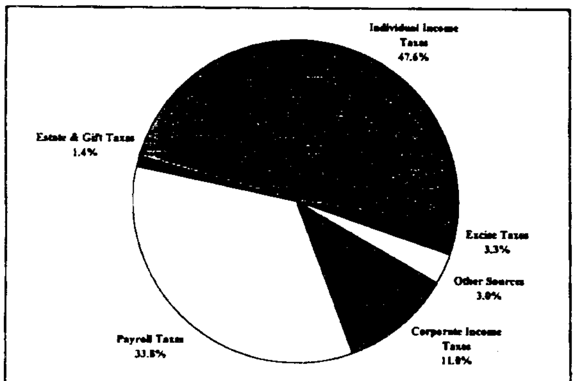
[44] See, for example, Gerald Auten and David Joulfaian, "Charitable Contributions and Intergenerational Transfers," *Journal of Public Economics* 59, no. 1 (January 1996): 55-68; and Charles T. Clotfelter, *Federal Tax Policy and Charitable Giving* (Chicago, IL: University of Chicago Press, 1985).
[45] Thomas Barthold and Robert Plotnick, "Estate Taxation and Other Determinants of Charitable Bequests," *National Tax Journal* 37, no. 2 (June 1984): 225-237.
[46] See Charles W. Christian, James R. Boatsman and J. Hal Reneau, "The Interpretation of Econometric Estimates of the Tax Incentive to Engage in Philanthropy," *Journal of the American Taxation Association* (Spring 1990): 7-16; and William S. Reece and Kimberly D. Zieschang, "Consistent Estimation of the Impact of Tax Deductibility on the Level of Charitable Contributions," *Econometrica* 53, no. 2 (March 1985): 271-293.
[47] Eugene Steuerle, "Charitable Giving Patterns of the Wealthy," in *America's Wealth and the Future of Foundations*, ed. Teresa Odendahl (New York, NY: The Foundation Center, 1987), 203-221.
[48] *Ibid.*, 217-218.

variety of reasons, to hold on to their wealth and make their charitable giving at death. Tax incentives may induce some donors to give their contributions earlier in life, but on balance, it appears that tax incentives (both income and estate) do not greatly alter the total amount of charitable giving made over an individual's lifetime.[49]

Other research confirm Steuerle's findings. An analysis by William Randolph of the Congressional Budget Office found that individuals "time their contributions to take advantage of transitory price changes."[50] Although taxes may affect the timing of gifts to charity, there may be no effect on the overall size of the donations. The effect of the tax deductibility of charitable contributions may therefore be analogous to "a family whose lifetime purchases of light bulbs are unaffected by price but which nonetheless buys all its bulbs when they are on sale."[51] Although Randolph does not directly address the issue of estate taxes, the implications are clear. Even if a reduction in the estate tax were associated with a decrease in the amount of charitable deductions made for estate tax purposes, there may be no long-term net effect since individuals may offset their reduction in donations at death with an increase in donations made during life.

C. Federal Revenue

Figure 1. Distribution of 1998 Federal Revenues



Source: Office of Management and Budget.

A third objection to cutting estate taxes is the alleged loss of revenue to the federal government. The estate tax accounts for a relatively small portion of federal revenue. Although the $23.1 billion that the estate tax raised in 1998 is hardly insignificant, it amounts to only about 1.4 percent of the $1.7 trillion in total receipts (Figure 1), a level that has remained relatively stable during the past

[49] A related argument has been put forth by Alan Reynolds, who observes that over the long run charitable donations represent a fixed share of GDP, a share that does not vary with changes in tax rates. Alan Reynolds, "Death Taxes and Giving: The Conventional Wisdom and Why It Is Wrong," *Philanthropy* (Winter 1997).

[50] William C. Randolph, "Dynamic Income, Progressive Taxes, and the Timing of Charitable Contributions," *Journal of Political Economy*, 103, no. 4 (1995): 735.

[51] Gerald E. Auten, Charles T. Clotfelter and Richard L. Schmalbeck, "Taxes and Philanthropy among the Wealthy," Working Paper No. 98-15, Office of Tax Policy Research, University of Michigan (December 1997), 29.

five decades.[52] In fact, the individual income tax raised more revenue in 1998 alone than the estate tax has raised during the entire 20th century.[53]

From a static revenue perspective, a reduction in either the rate of taxation or the tax base may result in a loss of revenue. However, there are at least two reasons why the traditional static analysis of the estate tax is inappropriate: estate tax avoidance strategies reduce income tax revenue, and revenue from estates is highly sensitive to the health of the economy.

Effect on Income Tax Revenue

The available data indicate that the estate tax may actually result in a net revenue loss for the federal government. The primary payers of the estate tax, the wealthy, tend to be well-educated about and willing to engage in extensive tax avoidance strategies. Moreover, it is difficult for any tax to assess accumulated savings and capital because such holdings can be manipulated through tax-free transfers and favorable asset valuation. These features of the estate tax led Joseph Stiglitz, former chairman of President Clinton's Council of Economic Advisers, to conclude that,

> Of course, prohibitively high inheritance tax rates generate no revenue; they simply force the individual to consume his income during his lifetime.[54]

A more in-depth examination of the net revenue effect of the estate tax is provided by Stanford University economist Douglas Bernheim.[55] As has been well documented, the estate tax affords many opportunities to avoid paying any tax at all.[56] However, such avoidance strategies principally occur by shifting resources from parents to their heirs prior to the parents' death. In general, revenue is lost whenever assets are transferred from parents in high income tax brackets to children (who typically face lower tax rates) or to tax-exempt organizations through charitable bequests.[57] Bernheim notes a few of the more relevant options used to avoid the estate tax:

- ***Direct gifts during life:*** The current estate tax allows up to $10,000 in annual tax-free gifts for each donor and recipient. Thus, a married couple with three children can transfer $60,000 each year to their heirs without paying taxes.

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[52] Office of Management and Budget, *FY 1999 Mid-Session Review* (Washington, DC: Government Printing Office, 1998), 23; and Office of Management and Budget, *Historical Tables of Budget of the United States Government, Fiscal Year 1997* (Washington, DC: Government Printing Office, 1997), 40-41, 169-170.

[53] Calculations use 1998 inflation-adjusted dollars and data from Office of Management and Budget, *Historical Tables*; U.S. Bureau of the Census, *Historical Statistics of the United States* (Washington, DC: Government Printing Office, 1976), 224; Jeffrey P. Rosenfeld, "Selected Components of Estate Portfolios, 1916-1990," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 94.

[54] Bevan and Stiglitz, 21.

[55] B. Douglas Bernheim, "Does the Estate Tax Raise Revenue?" in *Tax Policy and the Economy*, vol. 1, ed. Lawrence H. Summers (Cambridge, MA: MIT Press, 1987), 113-138.

[56] See generally, George Cooper, *A Voluntary Tax?: New Perspectives on Sophisticated Estate Tax Avoidance* (Washington, DC: Brookings Institution, 1979).

[57] This revenue effect holds regardless of whether or not the charitable deduction induces additional giving.

- ***Indirect gifts through advanced estate planning:*** Assets can also be transferred using sophisticated planning techniques such as issuing certain forms of stock in closely-held businesses or changing ownership of life insurance plans.

- ***Indirect gifts through profitable investment opportunities:*** Many parents are able to transfer wealth simply by letting their children participate in profitable investments in which they would not otherwise be involved. Parents can also provide low-cost financing or loan guarantees.

- ***Unreported gifts:*** These gifts include hard-to-detect transfers of assets such as family heirlooms, clothing or other household items.

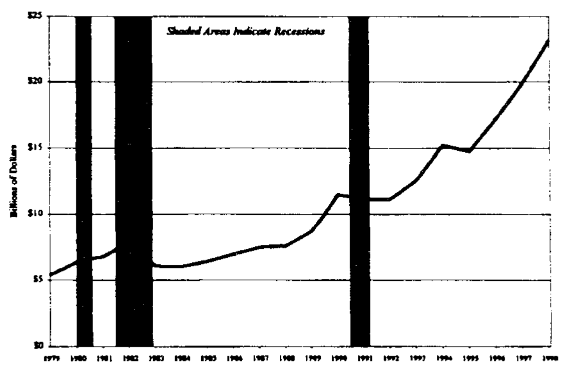
Through an analysis of estate tax returns under different assumptions and tax regimes, Bernheim found that the income tax revenue loss associated these factors is very large relative to the revenue raised by the estate tax. In sum, Bernheim concluded:

> Although it is very difficult to estimate these effects precisely, **in recent years true estate tax revenues may well have been negative.**[58] *(emphasis added)*

Health of the Economy

The second reason that static analyses fail to accurately measure the revenue effect of estate tax cuts is that estate tax revenue is highly sensitive to how the assets are valued, which in turn depends on the health of the economy.[59] To illustrate this effect, Figure 2 presents estate and gift tax revenue (in nominal dollars) from 1979 to 1998, covering both pre- and post-ERTA estate tax rates. Periods of economic recession are indicated with gray shading.

Figure 2. Estate Tax Revenue, 1979-1998



Source: Office of Management and Budget.

[58] Bernheim, 135.

[59] **In order to determine the value of the taxable estate, executors may choose to value assets either at the time of the decedent's death or six months thereafter. Thus, the prospect of an ailing economy affords executors the option of accepting the later valuation in order to minimize property values.**

On the surface, it would appear that the estate tax cuts that went into effect in 1982 (affecting estate tax returns filed in 1983) lost a significant amount of revenue. Between 1982 and 1983, estate tax revenue dropped 24 percent. However, consideration of the tax cut in isolation ignores other relevant factors. A better understanding of the actual revenue effect of the 1981 estate tax cut requires that the changes be examined in the context of the 1981-1982 recession.

The economy's poor performance significantly reduced the value of many estate assets, such as homes and corporate stocks.[60] Estate tax returns filed in 1983 primarily covered deaths in 1982. Thus, to see the effect of the economy on 1983 estate tax receipts, the appropriate point of comparison is how asset values changed in 1982 (when they were valued for estate tax purposes) relative to the previous year. Between August 1981 and January 1982, the median sales price of existing single-family homes dropped 2.5 percent.[61] Likewise, between the middle of 1981 and the middle of 1982, the New York Stock Exchange and the S&P 500 both fell close to 19 percent.[62] As home values and financial assets plummeted during the 1981-1982 recession, the diminished estate tax base resulted in revenue loss.

After the tax cuts were fully implemented, revenues grew steadily. Between 1983 and 1998, estate tax revenue more than tripled, increasing by 282 percent.[63] During that period, estate taxes were one of the fastest growing sources of revenue, outpacing the growth in total receipts, individual income taxes, payroll taxes, and excise taxes.

Table 2. Estate Tax Revenue, the S&P 500 and Median Sales Price of Homes

	Change in revenue	Change in S&P 500*	Change in median sales price of existing homes*
Year with large revenue decline			
1983	-24.3%	-18.6%	-2.5%
1991	-3.1%	-11.9%	-4.3%
1995	-3.0%	-4.0%	-2.0%
Year with large revenue increase			
1982	+17.7%	+30.6%	+17.6%
1990	+31.5%	+39.2%	+8.9%
1994	+21.1%	+14.4%	+7.0%

Source: Joint Economic Committee calculations.
* Indicates largest possible change. See note 64.

[60] IRS data indicate that just over one-half of the gross estates of 1983 returns was in either real estate or corporate stock. Mary F. Bentz, "Estate Tax Returns, 1983," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 3-14.
[61] The market value of more expensive homes likely experienced greater fluctuations during the recession that did the median home. Data from National Association of Realtors, "Home Sales" (monthly release).
[62] Data published in *The Wall Street Journal*.
[63] Calculations based on data from Office of Management and Budget, *Historical Tables*, 23-28, 40-41.

To further illustrate the relationship between the economy and estate tax receipts, Table 2 presents data on the three largest revenue jumps and declines since 1980. The first column of Table 2 lists annual changes in estate tax revenue. The next two columns present the largest possible change in the S&P 500 index and the median sales price of existing single-family homes.[64]

As the data clearly indicate, years characterized by a booming stock market and rising home values are associated with revenue increases. Likewise, years in which the stock market was weak or home prices dropped are associated with declines in revenue, regardless of changes in the estate tax regime. Although the estate tax cuts that were passed in 1981 may have had some effect on revenues, these data suggest that a large part of the observed revenue loss was attributable to the 1981-1982 recession. Over the long term, the data also suggest that estate tax revenues were boosted by ERTA to the degree that the tax cuts stimulated economic growth.

Other evidence confirms these findings. A 1996 study examined estate tax rates and revenues over four decades to conclude that higher estate taxes increase tax avoidance.[65] Thus, increasing (or decreasing) the estate tax does not necessarily mean an increase (or decrease) in revenue. In fact, the authors' statistical analysis suggests that marginal tax rates are *inversely* related to the revenue raised. That is, higher tax rates actually lower the amount of tax collections. This point is confirmed by Douglas Shackelford, who observes that revenue lost due to reduced estate taxes would be partially offset in two ways.[66] First, the substantial resources expended on tax avoidance strategies could be redeployed toward more fruitful uses, such as capital investment. Second, the elimination of the estate tax's administrative and compliance cost would allow businesses to increase productivity and efficiency.

IV. ARGUMENTS AGAINST ESTATE TAXATION

This section of the paper reviews the theoretical and empirical arguments against estate taxation. The four arguments considered here are that estate taxes: inhibit capital accumulation and economic growth; threaten the survival of family businesses and depress entrepreneurial activity; violate the fairness, simplicity and efficiency principles of tax policy; and adversely impact the conservation of environmentally sensitive land.

A. Economic Growth

Of all taxes imposed by the federal government, the estate tax is one of the most harmful to economic growth when measured on a per-dollar-of-revenue-raised basis. Although the estate tax is relatively small in terms of revenue raised, it exerts a disproportionately negative impact

[64] All data are nominal. For fiscal years with revenue decreases, change is measured as the difference between the low point of the previous calendar year and the high point of the year before that. For years with revenue increases, the points of comparison are the high point of the previous year and the low point of year before that.
[65] Kenneth Chapman, Govind Harihan and Lawrence Southwick, Jr., "Estate Taxes and Asset Accumulation," *Family Business Review* 9, no. 3 (Fall 1996): 253-268.
[66] Douglas A. Shackelford, "The Tax Environment Facing the Wealthy," Working Paper No. 98-5, Office of Tax Policy Research, University of Michigan (September 1997), 38.

on the economy. This section discusses some of the ways in which the estate tax hinders economic growth and reviews the empirical research on how the tax affects capital accumulation.

At its basest level, the estate tax adds yet another layer to the already heavy taxation of savings and investment. First, income is taxed at the individual level as it is earned. Second, interest or dividend income derived from savings or investments is subject to taxation. Third, capital gains taxes must be paid on the appreciated value of the asset, regardless of whether the asset value has increased beyond the rate of inflation. Fourth and lastly, savings and investments are hit by estate taxes when passed on to the next generation.

Inheritance (commonly referred to as "bequests" or "intergenerational transfers" in the economics literature) is simply the transfer of any unconsumed assets from one generation to the next.[67] Estate taxes are intended to reduce the volume of such transfers. To the degree that they reduce the amount of assets passed from individuals to heirs, estate taxes directly diminish the stock of capital in the economy.[68] The negative economic effects of wealth transfer taxes were noted as long ago as 1776, when Adam Smith wrote in his classic work *The Wealth of Nations*:

> All taxes upon the transference of property of every kind, so far as they diminish the capital value of that property, tend to diminish the funds destined for the maintenance of productive labour.[69]

Thus, by reducing the amount of capital available in the economy, estate taxes ultimately reduce the amount of wealth that ends up in the hands of workers. This negative effect on economic growth manifests in at least three ways. First, the estate tax has excessively high compliance costs. Although it is possible to avoid most, if not all tax liability on estates, doing so requires a substantial amount of planning and undesired allocation of resources. Alicia Munnell, a former member of President Clinton's Council of Economic Advisers, estimates that the costs of complying with estate tax laws are roughly the same magnitude as the revenue raised, or about $23 billion in 1998.[70] Thus, for every dollar of tax revenue raised by the estate tax, another dollar is squandered in the economy simply to comply with or avoid the tax.

Second, by affording so many tax avoidance options, the estate tax encourages owners of capital to shift resources from their most productive uses into less efficient (though more tax-friendly) uses. The estate tax introduces an extraneous element to resource allocation decisions that would otherwise be focused on maximizing economic efficiency. Estate tax planners must base their decisions in part on minimizing their estate tax liability. For instance, rather than investing in a more productive business opportunity, estate planners may elect a more tax-friendly option, such as some forms of life insurance or private charitable trusts. Regardless of how the resources are ultimately allocated, the fact that a criterion other than efficiency is included necessarily reduces output. David Ricardo identified this point over 180 years ago:

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[67] The estate tax nominally only applies to transfers made at death. However, since the punitive nature of the tax affects patterns of consumption and saving prior to death, the appropriate level of analysis is all transfers made.
[68] Throughout this paper, the term "capital stock" is used to refer to all privately-owned wealth and assets.
[69] Adam Smith, *The Wealth of Nations* (1776; reprint, Chicago, IL: University of Chicago Press, 1976), 391.
[70] Alicia H. Munnell, "Wealth Transfer Taxation: The Relative Role for Estate and Income Taxes," *New England Economic Review*, Federal Reserve Bank of Boston (November/December 1988): 19; Aaron and Munnell, 139; and Office of Management and Budget, *Mid-Session Review*, 23.

> [T]axes on the transference of property ... prevent the national capital from being distributed in the way most beneficial to the community. For the general prosperity there cannot be too much facility given to the conveyance and exchange of all kinds of property, as it is by such means that capital of every species is likely to find its way into the hands of those who will best employ it in increasing the productions of the country.[71]

Finally, and most importantly, the estate tax is a tax on capital, and as such it reduces the incentive to save and invest. The estate tax directly results in the loss of capital because it forces privately-held assets to be liquidated and transferred to governmental control. Wealth that would otherwise serve productive uses in the economy as capital assets, are transferred to consumption-intensive government uses.[72] According to James Poterba, an economist at the Massachusetts Institute of Technology, the federal estate tax increases the effective tax burden on capital income by 1.3 to 1.9 percentage points.[73] The effect is most pronounced for households headed by older individuals. For individuals age 70 to 79, federal estate taxes raise the tax on capital by approximately 1.7 to 2.7 percentage points, and for persons age 80 and up, the effective tax on capital is increased by between 14 and 19 percentage points.

By reducing the after-tax return on investment, the estate tax encourages consumption and discourages savings, which in turn cause the capital stock of grow at a slower rate. To illustrate this effect, consider a situation where parents must choose between leaving an asset to their children or consuming it themselves.[74] When faced with the 60 percent marginal tax rate, the "price" of bequeathing $1 is raised to $2.50. Alternatively, the parents could consume significantly more of that $2.50 for their own benefit. In the presence of high marginal estate tax rates, then, the decision between consumption and saving is significantly biased in favor of consumption. This effect may be particularly pronounced for those individuals (such as the elderly) who are most aware of their impending estate tax liability. Since their children will receive less than half of each additional dollar left as inheritance, many parents who are at the margin will choose to consume their savings. In his public finance textbook, Stiglitz, while admitting to some ambiguity, argues that on balance estate taxes "probably" reduce savings.[75]

To put the magnitude of estate tax disincentives in perspective, economists J.D. Foster and Patrick Fleenor of the Tax Foundation estimated the income tax rate equivalent of the estate

[71] David Ricardo, *The Principles of Political Economy and Taxation* (1817; reprint, Homewood, IL: Richard D. Irwin, Inc., 1963), 83.

[72] Only about 13 percent of the federal budget is spent on physical investments, research and development, and education and training programs. Office of Management and Budget, *Analytical Perspectives* of *Budget of the United States Government, Fiscal Year 1998* (Washington, DC: Government Printing Office, 1997), 102.

[73] If state death taxes are included, the total tax rate is raised by 1.7 to 2.5 percentage points. James Poterba, "The Estate Tax and After-Tax Investment Returns," Working Paper 98-11, Office of Tax Policy Research, University of Michigan (December 1997), 17, 40.

[74] There are many reasons why parents save and bequeath. For a review, see Carroll; and B. Douglas Bernheim, "How Strong Are Bequest Motives? Evidence Based on Estimates of Demand for Life Insurance and Annuities," *Journal of Political Economy* 99, no. 5 (October 1991): 899-927.

[75] Joseph E. Stiglitz, *Economics of the Public Sector*, 1st ed. (New York: W.W. Norton & Company, 1986), 487. A similar conclusion is reached by Laurence S. Seidman, "Taxes in a Life Cycle Growth Model with Bequests and Inheritances," *American Economic Review* 73, no. 3 (June 1983): 437-441.

tax.[76] In others words, they estimated what the income tax would have to be in order to result in the same after-tax estate (assuming the estate tax were repealed). Their analysis suggests that the present estate tax has the equivalent effect as an individual income tax rate of approximately 67 percent, significantly higher than the current top marginal rate of 39.6 percent. Corporate income taxes would have to be similarly adjusted, rising to roughly 68 percent. Thus, the estate tax has more or less the same disincentive effect as would the doubling of income tax rates.

As these arguments demonstrate, estate taxes directly and negatively impact economic growth by impeding the accumulation of capital. The direction of this effect is unambiguously negative, since the notion that capital is a critical determinant of economic growth is one of the most basic tenets of economics. For instance, noted economist Dale Jorgenson, writing with Barbara Fraumeni, concluded that "growth in capital input has emerged as the predominant source of U.S. economic growth during the postwar period."[77] The relevant question for the present discussion is not one of direction, but one of magnitude: to what *degree* are transfers of wealth from one generation to the next responsible for the accumulation of capital?

One answer to this question is provided by Boston University economist Laurence Kotlikoff and Lawrence Summers, who currently serves as the Deputy Secretary of the U.S. Treasury Department. Data presented by Kotlikoff and Summers in a pair of articles indicate that approximately 30 percent of the current stock of wealth is the result of bequests made at death.[78] However, another 10 to 36 percent of existing capital is attributable to other intergenerational transfers such as trusts and *inter vivos* gifts. Since it is clear that the estate tax induces avoidance through such transfers, it is appropriate to include them when considering the effect of the estate tax on capital accumulation. Thus, research by Kotlikoff and Summers indicates that between 41 and 66 percent of the current stock of wealth is attributable to the transfer of assets from one generation to the next.[79] The midpoint of this range is 53 percent.

Other research confirms this finding. Two separate studies, using distinct research approaches, arrived at nearly identical estimates of the share of wealth attributable to intergenerational transfers. In the first study, Brookings Institute scholar William Gale and John Karl Scholz (who formerly served in the Treasury Department as Deputy Assistant Secretary for Tax Policy) estimated in a 1994 study that 51 percent of wealth comes from bequests made at

[76] J.D. Foster and Patrick Fleenor, "The Estate Tax Drag on Family Business," *Family Business Review* 9, no. 3 (Fall 1996): 233-252.
[77] Barbara M. Fraumeni and Dale W. Jorgenson, "The Role of Capital in U.S. Economic Growth, 1948-1979," in *Measurement Issues and Behavior of Productivity Variables*, ed. Ali Dogramaci (Boston, MA: Kluwer Nijhoff Publishing, 1986), 163.
[78] Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy* 89, no. 4 (1981): 706-732; and Laurence J. Kotlikoff and Lawrence H. Summers, "The Contribution of Intergenerational Transfers to Total Wealth: A Reply," in *Modelling the Accumulation and Distribution of Wealth*, eds. Denis Kessler and André Masson (Oxford, England: Clarendon Press, 1988), 53-76.
[79] Kotlikoff and Summers actually estimate that intergenerational transfers account for 78 percent of accumulated capital. Their definition of transfers, however, includes transfers which some critics argue should not be classified as wealth transfers (such as expenditures for their children's college education). To follow a more conservative approach, the range used in this paper, and indicated in the text above, excludes education expenditures. See the Appendix for description of the methodology for these calculations.

death and other asset transfers made before death.[80] The second study, by Henry Aaron and Alicia Munnell, arrived at a comparable figure of 52 percent.[81] Not only are the estimates of 51 percent and 52 percent nearly identical, but they are also remarkably close to the midpoint of the range of estimates based on Kotlikoff and Summers' research. Based on the research reviewed here, it would therefore appear reasonable to conclude that roughly one-half, and perhaps more, of all privately-held capital is transferred from previous generations.[82]

A comprehensive estimate of all the negative impacts of the estate tax on economic growth is beyond the scope of this paper. However, Kotlikoff and Summers provide an econometric framework for analyzing the effect of the estate tax on the existing capital stock. According to their research, every $1 reduction in the annual flow of intergenerational transfers is associated with a corresponding loss of roughly $39 in the long-run amount of capital in the economy.[83] Over the past two decades, estate tax revenue has equaled approximately 5.9 percent of the annual flow of asset transfers. If one assumes that all this revenue would otherwise have been preserved as capital, then it is possible to arrive at a rough estimate of the wealth effect of the estate tax.[84] If annual asset transfers had been 5.9 percent higher, the amount of privately-held capital in the economy would have been $497 billion higher in 1995, an increase of approximately 3.2 percent.[85]

Survey data provide an alternative way to quantify the effect of the estate tax on economic growth. A 1995 survey of family-owned equipment distributors found, among other things, that close to one-half (46 percent) of these firms restructured their business ownership solely for estate tax purposes, at an average cost of $149,000.[86] Moreover, these businesses spent an average of $434,000 in gift taxes related to the transfer of ownership, and a cumulative total of $170,000 on life insurance policies (a common means of providing funds to pay the expected estate tax liability). Most of these expenditures occurred solely as a result of estate tax planning. Without the estate tax, these expenditures could be redirected to purchase additional labor and capital.

[80] William G. Gale and John Karl Scholz, "Intergenerational Transfers and the Accumulation of Wealth," *Journal of Economic Perspectives* 8, no. 4 (Fall 1994): 156.
[81] Aaron and Munnell, 131.
[82] In contrast to the three studies cited here, Modigliani estimates that intergenerational transfers account for a significantly smaller share of total wealth. Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives* 2, no. 2 (Spring 1988): 15-40.
[83] Both Gale and Scholz and Aaron and Munnell arrive at smaller estimates of this relationship. Data from Gale and Scholz imply that $1 in transfers produces roughly $37 in long-term wealth, while the comparable figure from Aaron and Munnell's data is $35. See *infra* note 85 and the Appendix for a fuller explanation.
[84] While this assumption may be overstated to the degree that some assets are not liquidated to pay estate taxes, it is understated to the degree that it fails to account for the distortionary effects and compliance costs of the estate tax.
[85] This figure is an estimate of the long run, steady-state effect of the estate tax. It is, in other words, an attempt to calculate how much larger the capital stock would be if there had no estate tax at all. See the Appendix for a more detailed discussion of the methodology and the sensitivity of the estimates to certain behavioral assumptions.
[86] Joseph H. Astrachan and Craig E. Aronoff, "A Report on the Impact of the Federal Estate Tax: A Study of Two Industry Groups" (Marietta, GA: Kennesaw State College, Family Enterprise Center, 1995).

Finally, the effect of eliminating the estate tax can be estimated using macroeconomic simulation models. While such models suffer from a number of intrinsic weaknesses, they nonetheless shed some light on the potential outcome of estate tax repeal. A simulation commissioned by the Research Institute for Small & Emerging Business estimated that repeal of the estate tax would produce a number of substantial benefits, including larger gross domestic product, more jobs, and lower interest rates (Table 3).[87] In addition, the economic effects would fully offset the annual static revenue loss by the fifth year.

Table 3. Macroeconomic Impact of Estate Tax Repeal (After 7 Years)

Indicator	Change	Percent change
Gross domestic product (GDP)	+$33.5 billion	+0.4%
Employment	+240,000	+0.2%
Disposable personal income	+$24.4 billion	+0.4%
Private investment	+$14.3 billion	+1.1%
Long-term interest rates	-22 basis points	NA

Note: Dollar amounts are in inflation-adjusted 1992 dollars.
Source: Research Institute for Small & Emerging Business.

B. Family Businesses and Entrepreneurial Activity

Aside from the aggregate effect on capital accumulation and economic efficiency, the estate tax exerts a strongly negative influence on entrepreneurial activity. As distinguished from the direct build-up of capital investment, entrepreneurial activity infuses the economy with risk-takers willing to exploit new technologies and enables families to achieve upward income mobility. By hindering entry into self-employment and by breaking up family-run businesses, the estate tax inhibits economic efficiency and stifles innovation.

Small businesses are a critical component of the American economy. According to the National Federation of Independent Business, small businesses have accounted for roughly two out of every three new jobs created since the early 1970s.[88] Such firms are a major contributor to economic growth. A survey of family-owned businesses reveals that two-thirds enjoyed positive revenue growth in the previous year and that the typical family-run business employs 50 full-time workers.[89] Small businesses further account for upwards of 10 percent of the economy's non-residential fixed investment, amounting to around $85 billion in 1997.[90]

The past two decades have witnessed a remarkable increase in the number of self-employed individuals operating small businesses. As these entrepreneurs age, more and more small businesses will be forced to deal with the looming burden of estate taxes. A survey of family-

[87] Analysis assumes the estate tax repeal takes effect in 1997. Research Institute for Small & Emerging Business, "The Effects of the Federal Estate and Gift Tax on the Aggregate Economy" (Washington, DC: Research Institute for Small & Emerging Business, 1998).
[88] James Wicket, National Federation of Independent Business, Testimony to the Subcommittee on Tax, Finance and Exports, Committee on Small Business, U.S. House of Representatives, 6/12/97.
[89] Arthur Andersen Center for Family Business and MassMutual, "American Family Business Survey '97" (1997), online at http://www.massmutual.com/fbn/html/res97.html.
[90] Robert Carroll, Douglas Holtz-Eakin, Mark Rider, and Harvey S. Rosen, "Entrepreneurs, Income Taxes, and Investment," National Bureau of Economic Research, Working Paper 6374 (January 1998), 1; Council of Economic Advisers, *Economic Report of the President 1998* (Washington, DC: Government Printing Office, 1998), 302.

owned businesses by Arthur Anderson and MassMutual found that the next few years will see an unprecedented number of family business successions. According to the survey, 28 percent of family businesses expect the current leader to retire in the next five years and 53 percent to retire in the next 10 years.[91] Thus, in the absence of additional tax relief, the adverse impact of estate taxes on family businesses is likely to greatly increase over the next five to 10 years.

The existing tax code already offers family businesses limited estate tax relief. Family-run businesses may apply to the IRS to pay their estate tax bill in installments over 14 years.[92] This is particularly useful for family farms, which may be asset-rich and cash-poor. Family businesses may also attempt to apply special valuation rules to their enterprise, which allows them to be valued at their current actual usage, rather than at a potentially more valuable usage.[93] In addition, the Taxpayer Relief Act of 1997 introduced an additional tax exclusion for qualifying family-owned businesses.[94]

Although these tax provisions do provide some relief, they are often inadequate to prevent the estate tax from breaking up many family businesses. Survey data indicate that the estate tax continues to be a primary reason why small businesses fail to survive beyond one generation. In fact, the estate tax is more likely to be the cause of failure during business succession than is the health or success of the business itself. A survey of family business owners by Prince & Associates found that 98 percent of heirs cited "needed to raise funds to pay estate taxes" when asked why family businesses fail.[95]

Despite the provisions noted above, IRS data indicate that between 1990 and 1996, more than 20,000 estate tax returns paid taxes on closely-held businesses worth a cumulative total of $34 billion in 1997 dollars.[96] Return data also indicate that another $15.5 billion in other noncorporate businesses were subjected to the estate tax, including farm assets, limited partnerships and other noncorporate businesses. Thus, upwards of $50 billion in small and family businesses were subjected to the estate tax over the last seven years. Moreover, stringent eligibility requirements and IRS hostility to favorable valuations limit the use of the tax benefits noted above.[97]

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[91] Arthur Andersen Center for Family Business and MassMutual. See also, Daniel Golden, "Family Fortune, Family Feuds," *The Boston Globe*, 12/14/97.

[92] Joint Committee on Taxation, *Estate and Gift Taxes*, 6-7.

[93] See Gary L. Maydew, "How to Convey a Family Business without Raising a Bumper Crop of Inheritance Taxes," *The National Public Accountant* (April 1995); and Thomas I. Hausman, "Family Limited Partnerships," *Tax Notes Today*, 1/5/98.

[94] Joint Committee on Taxation, *Estate and Gift Taxes*, 4-5.

[95] Russ Alan Prince and Karen Maru File, *Marketing to Family Business Owners* (Cincinnati, OH: National Underwriter, 1995), 35.

[96] This is a highly conservative estimate of the number of firms affected by the estate tax since it ignores businesses that did not pay estates taxes, either because they expended enough resources to avoid the tax or because the costs of estate planning impeded the growth of such firms. In addition, the figure does not account for family firms that are not classified as closely-held businesses. Eller, 24-47; Barry W. Johnson, "Estate Tax Returns, 1989-1991," in *Compendium of Federal Estate Tax and Personal Wealth Studies*, ed. Barry W. Johnson (Washington, DC: Internal Revenue Service, 1994), 51-85; and Internal Revenue Service, "Estate Tax Returns Filed in 1996" (4/16/98), online at http://www.irs.ustreas.gov/prod/tax_stats/soi/est_etr.html.

[97] See, Jeffrey N. Kelm and Jeffrey M. Wright, "IRS Assaults on FLPs; Family Limited Partnerships," *Tax Adviser*, 11/97; and Jerry A. Kasner, "Untangling the Family-Owned Business Exclusion," *Tax Notes Today*, 10/15/97.

Although it is impossible to know the ultimate disposition of all family firms subjected to the estate tax, perhaps as many as 28 percent are either sold or discontinued, totaling around 5,600 family businesses thus far in the 1990s.[98] Although family firms are discontinued for many reasons, it would seem reasonable in light of the Prince & Associates survey to conclude that the estate tax has contributed to the sale or dissolution of thousands of family firms.

According to the Prince & Associates survey, firms that failed during the transition from parents to children tended to be financially successful, with a median number of employees of close to 100.[99] The vast majority (91 percent) of these failed businesses had experienced average annual growth rates of more than 5 percent in the preceding five years. Given these figures, it is not surprising that at the 1995 White House Conference on Small Business, repeal of the estate tax ranked fourth on the Conference's list of 60 formal recommendations, garnering the support of close to 80 percent of the Conference delegates.[100]

[98] Calculations based on sale and discontinuance rates for businesses 13 years or older that were stilled owned by the founder. Thomas J. Holmes and James A. Schmitz, Jr., "On the Turnover of Business Firms and Business Managers," Federal Reserve Bank of Minneapolis (April 1994), Table 4.
[99] Prince and File, 36.
[100] White House Conference on Small Business, "60 Recommendations" (1995), online at http://www.whcsb.org:81/fropen.htm.

Table 4. Estate Taxes and Family Business (amounts are median unless otherwise indicated)

	All	Sub-group surveys		
	Firms	Farm	Black	AED
Impact of paying estate taxes:				
Aware of their estate tax liability	55%	–	43%	65%
Less willing to wait for an investment to pay for itself	36%	46%	–	–
Less likely to invest in higher risk projects	68%	68%	–	–
Makes growth of business more difficult	61%	–	90%	96%
Makes survival of business more difficult	64%	–	87%	93%
If due tomorrow, percent selling or liquidating	33%	37%	29%	31%
Number of jobs that would be lost	30	23*	4	18
Percent hiring more people if tax were eliminated	60%	54%	–	–
Number of new jobs that would be added	5	13*	–	–
Average cumulative amount spent on:†				
Lawyers	$16,113	$12,100	$14,206	$19,908
Accountants	$14,632	$8,100	$12,215	$11,940
Other financial advisers	$2,392	$1,300	$13,143	$11,212
Life insurance policies	$318,074	$176,100	–	$169,843
Annual cost of life insurance	$45,576	$16,400	$28,350	$26,778
Characteristics of businesses:				
Year business founded	1953	1954	1984*	1957*
Percent in first-generation	19%	21%	100%	42%
Total number of employees	80	47	96*	45
Jobs created in last 5 years	–	–	10	9
Annual revenue growth over last 5 years	7%	–	–	–
Annual revenue growth over next 5 years	6%	–	–	–

* Average.
† Average among responding firms.
Source: Ward, Mendoza, Astrachan, and Aronoff; Astrachan and Kaplan; and Astrachan and Aronoff.

Table 4 presents the results of a series of surveys conducted among family business owners. These surveys were conducted by researchers at the Family Enterprise Center of Kennesaw State College and the Center for Family Business at Loyola University.[101] The data consist of a large survey of family firms (first column) that included a sub-sample of family farms (column 2). In addition, two separate surveys examined black-owned firms (column three) and firms associated with the manufacturing industry (members of the American Equipment Distributors (AED), column four). The surveys asked respondents a series of questions about the impact of estate taxes and the characteristics of their business.[102]

[101] John L. Ward, Drew Mendoza, Joseph H. Astrachan, and Craig E. Aronoff, "Family Business: The Effect of Estate Taxes" (Chicago, IL and Marietta, GA: Center for Family Business and Family Enterprise Center, 1995); Astrachan and Thomas E. Kaplan, "The Impact of Federal Estate Taxes on Family Business and the Agriculture Industry" (Kennesaw, GA: Family Enterprise Center, 1997); and Astrachan and Aronoff.

[102] Since not all questions were asked in every survey, only the published results are presented.

As can be seen in Table 4, a sizeable minority of family businesses are unaware of their potential estate tax liability. Overall, only slightly more than one-half (55 percent) of family-run firms are aware of the potential estate tax bill. The awareness of the future estate tax bill is somewhat higher among manufacturing firms and somewhat lower among black-owned firms.[103] Such figures are of concern because they suggest that despite the high cost of estate taxes, many family firms are failing to adequately prepare for succession to the next generation.

Importantly, planning for estate taxes reduces the resources available for investment and employment. One reason for this is that the need to pay future estate taxes encourages business owners to keep liquid assets available. Thus, rather than investing in a profitable expansion or project, business owners may feel obligated to hold cash or other liquid assets in case the need to pay the estate tax arises.[104] According to the general family-business survey (column one of Table 4) more than one in three respondents stated that as a result of their expected estate tax liability, they were less likely to wait for an investment to pay for itself. Close to seven in 10 respondents felt that the estate tax made them less likely to invest in higher risk projects.

Approximately 61 percent of the businesses reported that the estate tax made the long-term growth of their business more difficult or impossible. A similar percentage (64 percent) believed that the estate tax threatened the very survival of their business. Respondents from the AED and black-owned sub-groups reacted much more negatively to the estate tax. Nearly all (96 percent) the manufacturing firms and 90 percent of the black-owned firms felt that the estate tax impeded their long-term business growth. Similarly large majorities of these firms (93 percent and 87 percent respectively) reported that the estate tax made survival of their family business either more difficult or impossible altogether.

Among all family firms, one-third believed that if the principal owner of their family-business died tomorrow, the heirs would be forced to sell off or liquidate part of their business. If such an action were taken, a median of 30 jobs would be destroyed. Remarkably similar results were reported for each of the three sub-groups, ranging from 29 percent for black-owned firms to 37 percent for family farms. The number of jobs that would be lost ranged from four for black-owned firms to 23 for farms. Conversely, if the estate tax were eliminated, most family businesses (60 percent) would hire additional employees, with the typical firm adding five workers.

The direct costs of estate tax planning are alarmingly high. The average amount already spent on lawyer fees was over $16,000. The cost of accountants involved in estate planning averaged more than $14,000, while other financial advisers have cost approximately $2,400. Among family firms that have purchased life insurance as a means of covering their estate tax bill, the typical cost-to-date totaled more than $318,000. The average cost of life insurance premiums was over $45,000 each year. Although the three sub-group surveys indicate that those businesses spent less on annual life insurance premiums, it is not clear why they spent less. Two

[103] The lower level of awareness among black-owned firms may be attributable to their younger age. The average starting year of the black-owned firms in this survey was 1984, compared to starting years in the 1950s for other family businesses.

[104] A formal model of this dynamic can be found in Rubin Saposnik, James Tomkins and Roger Tutterow, "Estate Taxes and the Investment Decision in Closely Held Firms," *Family Business Review* 9, no. 1 (Fall 1996): 315-320.

possible explanations are that respondents were simply unable to afford higher premiums or that they failed to accurately perceive the magnitude of their estate tax liability.

The harmful impact of the estate tax is further highlighted by the degree to which these firms were successful and created jobs. The median number of employees at the firms in the survey was 80. The farm and manufacturing firms had a median of 47 and 45 employees respectively, while black-owned businesses employed an average of 96 workers. In addition, the typical family-owned firm had experienced 7 percent annual growth in gross revenues over the previous five years. Such firms also projected that their future revenue would grow at an average annual rate of 6 percent.

A separate study by MassMututal (not listed in Table 4) found that family business owners are more concerned with estate taxes than they are with capital gains taxes. Although the income tax was identified as the tax of greatest concern by 38 percent of respondents, more than twice as many owners cited the estate tax (28 percent) than the capital gains tax (14 percent). This finding led the sponsors of the survey to conclude that,

> Advocates of reducing tax burdens on business to stimulate economic growth have traditionally placed a greater emphasis on capital gains taxes than on estate taxes. When it comes to family businesses, however, estate tax reform would appear to be more welcome – and may be a greater stimulus.[105]

To the degree that the estate tax disrupts the transmission of a family business to succeeding generations, the estate tax impedes upward income mobility. Entrepreneurship is a key means by which lower-income households move to a higher-income class. For instance, one study found that low-wealth workers who become self-employed are more than twice as likely to move to a higher wealth class than are individuals who continue traditional work.[106] Other data show that self-employment is an increasingly common trait of the wealthy.[107]

Concerns about the obstacles involved in passing a family business on to the next generation are especially prevalent among minority groups. Research indicates that the intergenerational link of self-employment is stronger for blacks than for whites.[108] That is, blacks are more likely to become self-employed if their parents are self-employed than are other ethnic groups. Thus, by making it more difficult for blacks to continue their family business, the harmful effects of estate taxes are magnified for black-owned enterprises. Moreover, intergenerational transfers are a major aid in allowing blacks to start their own businesses, since data indicate that asset levels are more important in determining self-employment among blacks than among whites.[109] In fact,

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[105] MassMutual, "1995 Research Findings" (1995), online at http://www.massmutual.com/fbn/html/res95.html.
[106] Vincenzo Quadrini, "Entrepreneurship, Saving and Social Mobility," Federal Reserve Bank of Minneapolis, Discussion Paper 116 (March 1997).
[107] Using data from the 1992 Survey of Consumer Finances, Wolff shows that 69 percent of the wealthiest 1 percent of Americans were self-employed. That figure is dramatically higher than the 1983 level of 38 percent. Edward N. Wolff, "Who Are the Rich? A Demographic Profile of High-Income and High-Wealth Americans," Working Paper No. 98-6, Office of Tax Policy Research, University of Michigan (September 1997), 12.
[108] Robert W. Fairlie, "The Absence of the African-American Owned Business: An Analysis of the Dynamic of Self-Employment," *Journal of Labor Economics* (forthcoming).
[109] *Ibid.*

wealth accumulation is considered such an important issue in minority communities that the lead essay in the National Urban League's *The State of Black America 1998* concluded "new and bold policy initiatives are needed to help African Americans accumulate assets to undergird their own social mobility and that of their children."[110]

For many low-income minority or ethnic groups, the estate tax represents a major obstacle to a successful family business. The survey of black-owned family firms (cited above) asked owners to rate their level of concern over the estate tax. On a scale of one to ten (with ten being the greatest concern), more than one-half of respondents answered with a nine or a ten.[111] The importance of passing a family business to the next generation was the subject of a 1995 article in the magazine *Black Enterprise*, which reported:

> Leaving a legacy for future generations is a key motivation for pursuing entrepreneurship, particularly for African Americans. But achieving that legacy isn't easy. Only one in three family firms survives two generations; only one in six survives three generations. "The challenge is not starting a family business, but being able to pass it on from generation to generation," says John Sibley Butler, professor of management and chairman of sociology at the University of Texas at Austin.[112]

A similar sentiment is reflected in the advice of the financial planning book *The Black Woman's Guide to Financial Independence*:

> Estate taxes are the most expensive taxes you will ever have to pay. The federal estate tax has graduated rates ranging from 40-55%. The more you have, the higher the tax rate. This is money you have earned and should be passed on to your heirs instead of to the federal government.[113]

The burdensome nature of the estate tax is illustrated by the story of Chester Thigpen. Thigpen, the great-grandson of slaves, managed to scrape up enough funds to buy some land in 1940. Eventually, he obtained enough land to start a tree farm in 1960. After close to four decades, the business is still a family-run operation. However, land prices have increased so rapidly that the Thigpen family faces the prospect of dismantling the very business that allowed them to achieve a higher standard of living. Thigpen's testimony to the Ways and Means Committee in Congress highlights these issues:

> It took us half a century, but Rosett and I have managed to turn our land into a working Tree Farm that has been a source of pride and income for my entire family. Our Tree Farm made it possible to put our five children through college. It made it possible for Rosette and me to share our love of the outdoors and our commitment to good forestry with our neighbors. And finally, it made it possible for us to leave a legacy that makes

[110] Melvin L. Oliver and Thomas N. Shapiro, "Closing the Asset Gap," in *The State of Black America 1998* (Washington, DC: National Urban League, 1998).
[111] Astrachan and Aronoff, B-11.
[112] Adreienne S. Harris, "Saluting the Past, Shaping the Future; The Future of Black-Owned Family Business," *Black Enterprise*, 8/95.
[113] Cheryl D. Broussard, *The Black Woman's Guide to Financial Independence* (New York, NY: Penguin Books, 1996), 151.

me very proud: beautiful forests and ponds that can live on for many, many years after my wife and I pass on. ...

Right now, people tell me my Tree Farm could be worth more than a million dollars. All that value is tied up in land or trees. We're not rich people. My son and I do almost all the work on our land ourselves. So, under current law, my children might have to break up the Tree Farm or sell off timber to pay the estate taxes.[114]

Entrepreneurial Survival and Liquidity Constraints

The principal reason that estate taxes cause such disruption to family businesses is that they impose large cash demands on firms that generally have limited access to liquid assets. For example, the typical small business owner has 60 percent of the family net worth invested in the business.[115] Moreover, financial markets may not provide adequate capital to small businesses on account of imperfect information.[116] Smaller firms, therefore, may be unable to obtain the optimal amount of capital required to finance their investments. Intergenerational transfers function, in essence, as a sort of internal financing mechanism. To the degree that estate taxes reduce or limit intergenerational transfers, they also reduce the amount of financing available for investment in small or family-run enterprises.

The available empirical evidence supports the contention that liquidity constraints (not all of which are attributable to estate taxation) significantly impede the ability of new businesses to succeed and grow. For example, one analysis found that smaller firms have difficulty obtaining the optimal amount of external capital financing.[117] A 1989 study estimated that liquidity constraints prevent approximately 1.3 percent of the population from chosing self-employment.[118] Similarly, a 1998 study reported that the most common reason traditional workers did not become self-employed was the shortage of available capital.[119]

The individuals who are most adversely impacted by liquidity constraints are lower-income persons who have the motivation and talent to start their own firm, but lack the necessary capital. As one of the studies cited above notes:

[Liquidity] constraints mean that a wealthier person can start a business with a more efficient capital level and thereby realize a greater return than a poorer one. ... Only high-ability/low-asset people are affected by the wealth constraint. But it is precisely these people who are most likely to want to switch to self-employment. Those with

[114] Chester Thigpen, Testimony to the Committee on Ways and Means, U.S. House of Representatives, 2/1/95.
[115] Ward, Mendoza, Astrachan, and Aronoff, 29.
[116] In fact, imperfect information may impose liquidity constraints even in otherwise functioning credit markets. See Joseph E. Stiglitz and Andrew Weiss, "Credit Rationing in Markets with Imperfect Information," *American Economic Review* 71, no. 3 (June 1981): 393-410.
[117] Steven M. Fazzari, R. Glenn Hubbard and Bruce C. Peterson, "Financing Constraints and Corporate Investment," *Brookings Paper on Economic Activity* 1 (1988): 141-206.
[118] David S. Evans and Boyan Jovanovic, "An Estimated Model of Entrepreneurial Choice under Liquidity Constraints," *Journal of Political Economy* 97, no. 4 (August 1989): 824.
[119] David G. Blanchflower and Andrew J. Oswald, "What Makes an Entrepreneur?" *Journal of Labor Economics* 16, no. 1 (January 1998): 26-60.

high ability can earn more in self-employment than in wage work, especially if they have poor wage earnings. But those with poor wage earnings are also likely to have accumulated relatively few assets.[120]

Inheritances play an important role in alleviating the liquidity constraints that impede the formation and success of small businesses. A 1994 study found that individuals who receive an inheritance are more likely to become self-employed, and those who are already self-employed are more likely to remain so.[121] Overall, the authors estimate that receiving a $150,000 inheritance (in 1985 dollars) results in a 1.3 percentage point increase in survival probability and a 20 percent increase in gross receipts. Another study by the same authors found that a $100,000 inheritance increased the probability of the recipient becoming self-employed by 3.3 percentage points.[122]

Other evidence further confirms the belief that intergenerational transfers play a major role in relieving liquidity constraints. A 1990 study in the *Quarterly Journal of Economics* examined patterns of *inter vivos* gifts.[123] The data show that such gifts generally occur in the form of loans or subsidies within family units. The givers tend to have greater amounts of financial assets, while the gifts themselves are targeted toward individuals who face significant liquidity constraints. Likewise, a 1998 article found that receipt of an inheritance significantly increased the probability of self-employment, and that "most small businesses were begun not with bank loans but with own or family money."[124]

C. Fairness, Simplicity and Efficiency

One of the most distinguishing attributes of the estate tax is the broad range of avoidance options it permits. There are so many legal loopholes in the estate tax that it has earned the nickname "the voluntary tax."[125] The tax avoidance options available to the estate planner are extensive and well-documented.[126] Virtually any individual who invests sufficient time, energy and money in tax avoidance strategies is capable of escaping the estate tax altogether. Some estate tax critics have noted that the only reason individuals submit to the tax at all is either ignorance of the available avoidance options or the avoidance options seemed too costly.[127]

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[120] Evans and Jovanovic, 819, 824.

[121] Douglas Holtz-Eakin, David Joulfaian and Harvey S. Rosen, "Sticking It Out: Entrepreneurial Survival and Liquidity Constraints," *Journal of Political Economy* 102, no. 1 (February 1994): 68-71.

[122] Douglas Holtz-Eakin, David Joulfaian and Harvey S. Rosen, "Entrepreneurial Decisions and Liquidity Constraints," *RAND Journal of Economics* 25, no. 2 (Summer 1994): 342. However, elsewhere Holtz-Eakin and Dunn found that liquidity constraints are not a major factor limiting *entry* into self-employment. Thomas Dunn and Douglas Holtz-Eakin, "Financial Capital, Human Capital, and the Transition to Self-Employment: Evidence from Intergenerational Links," National Bureau of Economic Research, Working Paper 5622 (June 1996).

[123] Donald Cox, "Intergenerational Transfers and Liquidity Constraints," *Quarterly Journal of Economics* 105, no. 1 (February 1990): 187-217.

[124] Blanchflower and Oswald, 51.

[125] Cooper.

[126] For a sampling, see Cooper; Bernheim; and Munnell.

[127] See Cooper, 79-82; and John E. Donaldson, "The Future of Transfer Taxation: Repeal, Restructuring and Refinement, or Replacement," *Washington & Lee Law Review* 50 (Spring 1993): 548.

The large number of tax avoidance options permitted under the estate tax means that the tax will result in a tax burden distributed unfairly among payers, be unnecessarily complicated, and significantly distort taxpayer behavior. According to the 1996 *Economic Report of the President*, "Three main traits define a well-designed tax system: fairness, economic efficiency, and simplicity."[128] This section of the paper demonstrates how the estate tax fails to meet any of these three criteria.[129]

Fairness

The fairness (or equity) of a particular tax is measured along two dimensions. The first dimension is vertical equity, which refers to the progressivity of the tax. A tax is said to be progressive when individuals with fewer resources pay less taxes than those with greater resources. Horizontal equity requires that taxpayers with the same amount of resources pay the same tax. That is, all taxpayers worth $1 million should have the similar estate tax liabilities.

The existence of so many loopholes virtually guarantees that the estate tax will violate the principles of horizontal and vertical equity. Taxpayers all along the income and wealth spectrum can eliminate or greatly reduce their estate tax liability with enough advance planning. Thus, an individual worth $5 million can not only pay less in estate taxes than other individuals worth $5 million, but can pay less than those worth $1 million. This aspect of estate taxation was summarized by Munnell, who wrote:

> Those people who take advantage of these [tax avoidance] opportunities will end up paying little or no tax, while those who do not plan ahead will pay significant amounts. Horizontal and vertical equity considerations have disappeared in the estate and gift area; **tax liabilities depend on the skill of the estate planner, rather than on capacity to pay.**[130] *(emphasis added)*

One way to measure vertical equity is to compare the average tax rates for different income or asset levels. Based on this criterion, the estate tax does not exhibit vertical equity. According to IRS data, the average estate tax rate for the largest estates (gross estates over $20 million) is actually *lower* than the average rate for estates in the $2.5 to $5 million range.[131]

Efficiency

The efficiency of a tax system refers to the costs of complying with the tax. An efficient tax should not impede economic growth or change the way people behave. Measured in these terms, the estate tax is highly inefficient. As previously noted, Aaron and Munnell estimate that the compliance costs of the estate tax are roughly the same size as the amount of revenue raised:

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[128] Council of Economic Advisers, *Economic Report of the President 1996* (Washington, DC: Government Printing Office, 1996), 84.
[129] These issues are explored in greater detail in Donaldson, 545-553.
[130] Munnell, 18.
[131] Internal Revenue Service, "Estate Tax Returns Filed in 1996."

> In the United States, resources spent on avoiding wealth transfer taxes are of the same general magnitude as the [revenue] yield, suggesting that the ratio of excess burden to revenue of wealth transfer taxes is among the highest of all taxes.[132]

In 1998, the estate and gift taxes raised $23 billion. However, based on Aaron and Munnell's analysis, the true cost to the economy of these taxes was closer to $46 billion. In other words, for every $1 removed from the economy to pay estate taxes, another $1 is wasted in order to comply with or legally avoid the tax.

Because the estate tax is so confiscatory, individuals are often compelled to alter the ownership structure of their assets in suboptimal manner. As noted above in the section Economic Growth, tax avoidance strategies interject an extraneous element (tax liability) into decisions regarding resource allocation. Restructuring a family business may reduce the estate tax liability, but doing so may also result in reduced production.[133] In addition, the estate tax clearly alters many people's consumption and saving decisions, encouraging the former and discouraging the latter.[134]

Simplicity

The estate tax and the attendant tax avoidance strategies constitute one of the most complex federal tax regimes. The basic tax form for estate tax returns (not counting gift taxes) totals 41 pages, and the accompanying instructions consume an additional 22 pages. The IRS itself estimates that properly completing the estate tax return takes close to one full work week -- over 36 hours. Assuming (generously) that the IRS estimate is accurate, 1996 estate tax returns consumed at least 2.9 million hours of labor – the equivalent of over 18,000 persons working full-time for a month.[135] The IRS estimate, however, likely understates the actual time required for estate planning. A 1995 survey of family business owners found that the actual time dedicated to estate planning was more than four times higher – 167 hours on average.[136] The complexity of filing an estate tax return is further seen in the fact that 86 percent of taxable estates in 1996 retained a lawyer, at an average cost of over $23,000.[137]

Although the estate tax affords many tax avoidance opportunities, taking advantage of such opportunities can be extremely complicated. For example, one tax avoidance strategy available to small businesses is a preferred stock recapitalization, in which one type of stock is issued to business owners and another type to heirs. Similarly, donating land to a conservation easement requires detailed knowledge of property valuation, eligibility requirements and ownership structures. Even a strategy as simple as taking advantage of the $10,000 annual gift tax exemption requires a significant amount of planning and record-keeping. Implementing any of

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[132] Aaron and Munnell, 139.
[133] See *supra* note 86 and accompanying text.
[134] See *supra* note 10, as well as text accompanying *supra* notes 73 and 104 and Table 4.
[135] Includes time spent on record keeping, learning about the law or form, preparing the form, and sending the form to the IRS. Internal Revenue Service, "Instructions for Form 706" (April 1997), 1; and Internal Revenue Service, "Estate Tax Returns Filed in 1996."
[136] Ward, Mendoza, Astrachan, and Aronoff, 24.
[137] Internal Revenue Service, "Estate Tax Returns Filed in 1996."

these tax avoidance strategies can be quite complicated and elaborate. A great deal of expertise is required in order to ensure compliance with all the tax rules and laws.

D. Environmental Conservation

An often-overlooked aspect of the estate tax is its harmful effect on the environment. The impact principally manifests when heirs are forced to sell or develop environmentally sensitive land in order to pay the estate tax. The problem of estate taxation faced by private landowners was one of the issues addressed by *The Keystone Report*. *The Keystone Report* represents the collective efforts of environmentalists, landowners, business groups, and government agencies to identify and recommend solutions to the problems that private landowners face in conserving threatened and endangered species and habitats. With regard to estate taxes, *The Keystone Report* found that:

> Federal estate tax requirements are a major obstacle for private landowners whose land stewardship has been sensitive to its environmental value and who would like to be able to pass on their land to their heirs without destroying that value. The imposition of federal estate taxes often forces large parcels of environmentally valuable land to be broken up into smaller, less environmentally valuable parcels. Some of the best remaining habitat for endangered species is put at risk in this manner.[138]

Landowners (particularly farmers and ranchers) often find themselves in a position where they are "land rich" and "cash poor." The problem was articulated by Doug Stinson, a family tree farmer and member of the American Tree Farm System:

> Today, family-owned Tree Farms and small businesses are still being destroyed by the federal estate tax because many of them are highly illiquid. For Tree Farmers, much of our cash is literally in our standing trees. You've heard the saying "land rich and cash poor." Well, that's an apt description of many forest landowners. The annual household income of the average Tree Farmer is less than $50,000. Yet on paper, the typical Tree Farm can be valued at well above $2 million. Even with the increase in the exemption under the unified credit and newly created business exclusion which provides a total exclusion of $1.3 million, the Death Tax "hit" on these forestlands can be several hundred thousand dollars. This forces many families to liquidate the timber, or even worse, to fragment the woodland by selling off pieces of their property.[139]

When the time comes to pay estate taxes, real estate assets often produce a substantial tax liability that can only be paid by selling the land for development. The impact of the estate tax is most apparent in terms of natural habitats that are destroyed. Endangered species are affected as well, since about one-half of all listed species are found only on privately-owned land.[140] These effects of estate taxation led Michael Bean of The Nature Conservancy to label the estate tax as

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[138] The Keystone Center, *The Keystone Dialogue on Incentives for Private Landowners to Protect Endangered Species – Final Report* (Washington, DC: Keystone Center, 1995), 26.
[139] Douglas P. Stinson, Testimony to the Committee on Ways and Means, U.S. House of Representatives, 1/28/98.
[140] The Keystone Center, 31.

"highly regressive in the sense that it encourages the destruction of ecologically important land in private ownership."[141]

In recognition of the adverse environmental impact of taxing estates, the current federal tax code grants limited estate tax relief for qualifying "conservation easements," land that is set aside for environmental conservation. As the law now stands, there are two provisions of the tax code that apply.[142] Under the first provision, land owners are exempt from paying estate taxes on the value of land that is lost due to the conservation easement. The Taxpayer Relief Act of 1997 supplemented the first provision by granting estates that donate such easements an additional tax deduction worth 40 percent (up to a maximum of $500,000) of the remaining value of the land.

The conservation easement provisions, however, fall considerably short of remedying the tax's adverse environmental impact. A number of factors limit the effectiveness of the conservation easement provisions. First, only a relatively small portion of land is even eligible to qualify as an easement. Estate tax law requires that a conservation easement be located either within 25 miles of a metropolitan area, national park, or national wilderness area, or within 10 miles of an urban national forest. However, the land covered by metropolitan areas and national parks represents a relatively small portion (less than 24 percent) of the U.S. total, leaving many environmentally-sensitive areas ineligible for conservation easements.[143] In addition, the Treasury Secretary may disallow some conservation easements by making the determination that the land is not under "significant development pressure."[144]

Second, some land may not qualify for a conservation easement because it is currently used for commercial purposes. However, the current commercial use may still be preferable to an alternative, higher-valued use. For example, land that is used for tree farming or grazing is generally less harmful to the environment than some residential or industrial applications. As one environmental activist put it, "cows are better than condos."[145] Nonetheless, the imposition of estate taxes may force land into less environmentally friendly uses.

Even with the limited conservation easement now in place, many estates will not, for a variety of reasons, take advantage of the option. In fact, the Office of Management and Budget estimates that deductions for conservation easements over the next five years (1999-2003) will reduce estate tax revenue by less than two-tenths of one percentage point (0.18 percent).[146] As Jean Hocker, president of the Land Trust Alliance, put it:

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[141] Michael J. Bean, "Shelter from the Storm," *The New Democrat* (April 1997).
[142] The specific aspects of the conservation easement provision of estate tax law are quite complicated. For a thorough treatment, see C. Timothy Lindstrom and Stephen J. Small, "New Estate Tax Relief for Land under Conservation," *Tax Notes Today*, 3/2/98.
[143] Calculation based on data from U.S. Bureau of Land Management, Department of the Interior, *Public Land Statistics 1997* (1998), online at http://www.blm.gov/natacq/pls97/part5.html; and U.S. Bureau of the Census, *Statistical Abstract*, 39, 250.
[144] Applies to easements that qualify due to their proximity to a national park or wilderness area.
[145] Comment by ornithologist Susan Lohr, in Eric Pooley, "Cows or Condos? Putting aside their Differences, Conservative Cattlemen and Left-Leaning Environmentalists Team up to Save a Valley," *Time*, 7/7/97.
[146] Office of Management and Budget, *Analytical Perspectives*, 41, 120.

> All too often heirs without other sizable assets with which to pay the estate tax bill must sell for development land that was previously undeveloped or in low impact use. So while current law does encourage sophisticated taxpayers with good estate planning advice to donate land or easements for conservation, land in the estate of a decedent who did not, or could not, take such steps will often have to be sold.[147]

One provision of the conservation easement law actually undermines the preservation of environmentally sensitive land – the reverse effect that was intended. This outcome results from the requirement that the easement must represent at least 30 percent of the land value in order to receive the full tax benefit. In other words, the easement must constitute a significant portion of the total land value in order to qualify for the favorable tax treatment. In many cases, however, existing federal laws or regulations have already reduced the value of environmentally important land. For example, the presence of wetlands or endangered species may have lowered the market value of the land subject to a conservation easement. According to one tax planning report,

> The 30 percent threshold may actually penalize the owners of land having wetlands regulated under section 404 of the Clean Water Act or providing habitat to endangered species under the provisions of the Endangered Species Act. This is because the existence of those conditions triggers federal regulation that may reduce the value of land to such an extent that a conservation easement will have only a negligible effect on its value. If that occurs it is likely that the requirement that the easement reduce the value of the land by at least 30 percent for the donor to enjoy the full 40 percent exclusion may deny the donor of an easement on federally regulated land any meaningful benefit under the new law. For the same reason an easement on such land may not result in any other significant tax benefits.[148]

Although most environmentalists would prefer expanding conservation easement options rather than complete repeal of the estate tax, it is nonetheless clear that the federal estate tax in its current form represents a continuing threat to endangered and threatened species and habitats.

VI. CONCLUSION

This paper has documented the extensive costs associated with the federal estate tax. The detrimental effects of the estate tax are grossly disproportionate to the modest amount federal revenue it raises (if it raises any net revenue at all). Estate taxes result in a large amount of wasted economic activity. Over its lifetime, the presence of the estate tax has cost the economy roughly one-half a trillion dollars in capital stock. Moreover, the estate tax destabilizes family businesses at one of their most vulnerable points, the succession from one generation to the next. The enormous liquidity demands of the estate tax have contributed to the break up of thousands of small businesses as well as the destruction of environmentally sensitive land. In generating these outcomes, the estate tax has violated the basic principles of a good tax system – simplicity, fairness and efficiency.

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[147] Jean Hocker, Testimony to the Subcommittee on Oversight, Committee on Ways and Means, U.S. House of Representatives, 7/16/96.

[148] Lindstrom and Small.

If the estate tax generated sufficiently large benefits, then an argument could be made to justify its existence. However, all the evidence indicates that the estate tax has no redeeming qualities. There is no theoretical or empirical basis to suggest that the estate tax promotes fairness or reduces inequality. In addition, research indicates that the deduction for charitable bequests stimulates little or no additional giving. Even the $23 billion in revenue it raises is illusory, since estate tax avoidance activities likely generate equally large revenue losses under the income tax.

The estate tax is an unfortunate feature of the current federal tax system. The estate tax's punitive tax rates are not only the highest of all federal taxes (reaching nearly 80 percent), but are imposed at the most inappropriate of times – the death of a loved one. As if mourning such a loss were not enough, the federal government worsens the pain by seeking to confiscate upwards of one-half of all the decedent's accomplishments and successes.

This final injurious grievance simply strengthens the conclusion that the estate tax generates costs to taxpayers, the economy and the environment that far exceed any potential benefits that it might arguably produce. The balance of evidence reviewed here suggests that this nation's forefathers followed the correct policy: in the absence of a national emergency, there is no compelling reason to warrant the permanent imposition of the estate tax. Death and taxes may indeed be inevitable, but these twin hardships need not always converge with consequences as burdensome and destructive as those of the estate tax.

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Senior Economist

APPENDIX: METHODOLOGY

Percent of Wealth from Intergenerational Transfers

In a pair of articles published in 1981 and 1988, Kotlikoff and Summers estimate that 78.1 percent of all wealth is attributable to intergenerational transfers.[149] However, this estimate includes an unspecified amount of non-asset transfers, such as expenditures by parents for their children's college education. Since the focus of this paper is the effect of estate taxes on the capital stock, it is necessary to isolate the portion of Kotlikoff and Summers' estimate that pertains to direct transfers of assets or wealth. Although Kotlikoff and Summers do not provide a precise estimate of such transfers, it is possible to identify the range of possibilities.

Table 5. Percent of Total Wealth Attributable to Intergenerational Transfers

Type of Transfer	Percent
Bequests	30.5%
Life insurance	2.9%
Trusts	7.1%
Educational expenditures	11.9%
Other transfers	25.7%
Total Intergenerational Transfers	**78.1%**

Source: Kotlikoff and Summers (1981 and 1988).

The data in Table 5 indicate the distribution of transfer wealth as estimated by Kotlikoff and Summers. Of the 78.1 percent of total wealth attributable to transfers, 11.9 percent is due to educational expenditures and do not count as direct asset transfers. Omitting such transfers leaves a remainder of 66.2 percent. Of this remainder, bequests, life insurance and trusts (all of which count as asset transfers) represent 40.5 percent, while 25.7 percent are other, unclassified transfers. Some of these unclassified transfers are in the form of assets, while others are not. By definition, then, the percent of wealth attributable to asset transfers must lie somewhere between 40.5 percent (where none of the "other" transfers are assets) and 66.2 percent (where all of the "other" transfers are assets). Thus, the Kotlikoff and Summers data suggest that the transfer of assets from one generation to the next accounts for at least 41 percent and perhaps as much as 66 percent of the total stock of wealth in the economy. The median of this range, 53.4 percent, is the value used to calculate the capital stock effects described below.[150]

Wealth Lost Due to the Estate Tax

Kotlikoff and Summers provide an econometric framework for analyzing the effect of the estate tax on the existing capital stock. In their 1988 paper, the authors present the following formula which defines the long run steady-state equilibrium stock of capital:

$$(1) \qquad T = \frac{t}{(r-n)} e^{(r-n)D}\left[1 - e^{(n-r)(G-I)}\right] e^{(n-r)I}$$

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[149] See *supra* note 78.

[150] As noted in the text above, other researchers have arrived at different estimates of the share of wealth attributable to intergenerational transfers. See *supra* notes 78 through 82 and accompanying text.

In Equation 1, T represents the accumulated stock of wealth that is derived from intergenerational transfers; t is the amount of wealth transferred between generations each year (or the flow of transfers); r is the after-tax interest rate; n is the population growth rate; D is the age of death; G is the age at which the gift (transfer) is made; and I is the age at which is the gift is received.[151] This equation allows the researcher to answer to following question: what level of annual intergenerational transfers are necessary to produce a given stock of wealth?

Equation 1 can be reduced to a simpler form if α is defined as:

$$\text{(2)} \qquad \alpha = \frac{e^{(r-n)D}\left[1-e^{(n-r)(G-I)}\right]e^{(n-r)I}}{(r-n)}$$

so that Equation 1 can be rewritten as follows:

$$\text{(1a)} \qquad T = t * \alpha$$

Assuming the values specified by Kotlikoff and Summers for the variables r, n, D, G, and I, α then becomes a constant with the value of 38.67. Equation 1a can now be re-written as:

$$\text{(3)} \qquad T = t * 38.67$$

Thus, the formulas and data supplied by Kotlikoff and Summers indicate in the long run, a \$1 increase in annual transfers results in \$38.67 in additional capital. The question now becomes: how much larger would the annual flow of transfers (t) be in the absence of the estate tax?

One simplified approach is to increase the annual flow of transfers by the amount of revenue raised by the estate tax. This approach, in effect, assumes that all tax revenue would otherwise have been passed on to younger generations in the form of assets. The validity of this assumption is difficult to assess, since there are arguments that the effect could be either greater or smaller. For example, if the elimination of the estate tax causes either decedents or their heirs to increase their consumption or reduce their level of work and saving, then the assumption may overstate the impact on the capital stock.[152] Conversely, if the elimination of the estate tax results in a more efficient allocation of resources, reduced consumption by decedents, or increased work and saving by decedents, then the assumption may understate the impact.[153] Without a better understanding of the motivations affecting bequests, there is no way to determine which factors are stronger. This paper avoids making such a determination by simply assuming that estate tax revenues represent resources that would otherwise have been left in the stock of capital.

[151] For a more detailed explanation of the formula and terms, see Kotlikoff and Summers, "Contribution of Intergenerational Transfers."
[152] For examples, see *supra* note 36 and Cox.
[153] For examples, see *supra* note 10, as well as text accompanying *supra* notes 73, 75, 104 and Table 4.

Since t represents the annual flow of capital in a steady-state equilibirum, the appropriate measure of lost intergenerational transfers is the average relative size of estate tax revenue over a long period of time. Equation 3 can be used, in conjunction with the data in Table 5 and a time-series estimate of the capital stock, to estimate the annual flow of intergenerational transfers.[154] Comparing these estimates to historical revenue data suggests that over the long run estate tax revenues are equal to at least 5.9 percent of the annual flow of intergenerational transfers. Increasing the 1995 inferred flow of capital by 5.9 percent yields an increase in the 1995 stock of privately-owned capital of $497 billion, equivalent to 3.2 percent of the $15.7 trillion total stock.

The magnitude of the wealth effect estimated here is largely a function of the value of α, which Kotlikoff and Summers estimate to be close to 39. Gale and Scholz do not directly estimate α. However, the aggregate flows and stocks that they publish in their article imply that α has a value of approximately 37. If data from Gale and Scholz are substitued for Kotlikoff and Summers' data, then the wealth effect of the estate tax is $473 billion. The data supplied in Aaron and Munnell's article indicate that α has a value of approximately 35. If Aaron and Munnell's data are used, then the wealth effect amounts to $449 billion.

One-half a trillion dollars might seem to some readers a disproportionately large effect for a tax that raises only about $23 billion a year. For this reason, it is important to keep in mind the meaning of these calculations. The estimates presented in the preceding paragraphs represent the long run, cumulative impact of the estate tax on the steady-state equilibrium stock of capital. In other words, $497 billion is an estimate of how much larger the capital stock would have been in 1995 if there had been no estate tax at all over a very long period of time, perhaps 50 or 100 years. In fact, $497 billion does not seem quite as large in comparison to the $585 billion in revenues the estate tax has collected over the last 60 years alone.[155] The best interpretation of the figure of $497 billion is as a rough estimate of what the estate tax has cost the economy in terms of lost capital stock since its inception in 1916.

[154] The measure of wealth used here includes all privately-owned fixed capital, not including durable goods owned by consumers. Arnold J. Katz and Shelby W. Herman, "Improved Estimates of Fixed Reproducible Tangible Wealth, 1929-95," *Survey of Current Business*, Bureau of Economic Analysis (May 1997): 69-92.
[155] In inflation-adjusted 1995 dollars. See *supra* note 53.

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Testimony of

The Associated General Contractors of America

presented to the

House Small Business Committee
Subcommittee on Tax, Finance and Exports

and

Subcommittee on Rural Enterprises, Business Opportunities, and Special Small Business Problems

on

The Death Tax

May 13, 1999

The Associated General Contractors of America (AGC) is a national trade association of more than 33,000 firms, including 7,500 of America's leading general contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects and site preparation/utilities installation for housing development.

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Testimony of
The Associated General Contractors of America (AGC)
on the Death Tax

Submitted to the
House Small Business Subcommittees on
Tax, Finance and Exports
and
Rural Enterprises, Business Opportunities, and Special Small Business Problems

May 13, 1999

Thank you, Chairman Manzullo and Chairman LoBiondo, for holding a hearing this morning on the effect of the death (estate) tax on family-owned construction companies. AGC is pleased to submit testimony today because elimination of the death tax is our top legislative priority for the 106th Congress. 94% of AGC members are closely-held businesses -- often family-owned -- and planning for and paying death taxes is an onerous burden our members will have to face at some point in the life of their company.

You'll notice throughout this testimony that we consistently refer to the estate tax as the "death tax." We prefer to call it the "death tax" for two reasons: 1) death of the owner of a company is the event that triggers the tax; and 2) at a rate of 37% to 55% on all company assets, this tax kills small businesses and kills jobs!

AGC is the nation's largest and oldest construction trade organization, founded in 1918. AGC represents more than 33,000 firms, including 7,200 of America's leading general contractors, and 12,000 specialty-contracting firms. They are engaged in the construction of the nation's commercial buildings, shopping centers, factories, warehouses, highways, bridges, tunnels, airports, waterworks facilities, waste treatment facilities, dams, water conservation projects, defense facilities, multi-family housing projects, and site preparation/utilities installation for housing developments.

EFFECT of DEATH TAXES on CONSTRUCTION COMPANIES

Business continuity - the passing of years of hard work to the next generation - is a great concern to family-owned construction companies. Succession planning is long and difficult. Owners are forced to answer to difficult questions about the future of the company they have often worked all their life to grow. Who will run the business when I'm gone? What does my family think should happen? How will ownership be transferred? These are just a few of the questions a contractor must address when undertaking succession planning.

As difficult as succession planning can be, it gets even worse when the owner realizes that up to 55% of his or her company can be lost to death taxes. When the owner of a construction company dies, his or her estate is subject to federal and state death taxes. The total value of the estate includes the value of the family business along with other assets such as homes, cash, stocks, and bonds. At a minimum, an estate over $650,000 (gradually increased to $1 million by 2006) will be subject to a federal death tax rate of 37% and an estate over $3 million will be taxed at an astronomical federal rate of 55%. This tax is on top of not only the state death tax but also the income, business, and capital gains taxes that have been paid over an individual's lifetime. It is not surprising, then, that more that 70% of family businesses do not succeed to the second generation and 87% do not survive to the third generation.

The construction industry is capital intensive, requiring large investments in heavy equipment. One single critical company asset can cost more than the amount ($650,000) of the unified credit. For instance, a 150-ton crane used in bridge construction can cost more than $1 million. A scraper can cost $700,000 and a large bulldozer can cost more than $800,000.

Most family-owned construction firms invest a significant portion of their after-tax profits in equipment, facilities and working capital. This is necessary for these firms to increase their net worth, create jobs and continue to be bonded for larger projects. Because of these assets, the construction industry is especially vulnerable to the devastating effect of the death tax.

Those family-owned construction companies that do survive after death taxes have spent thousands, sometimes millions, of dollars to plan for and pay death taxes. Of AGC firms involved in estate planning, 63% purchase life insurance, 44% have buy/sell agreements and 29% provide lifetime gifts of stock.

Last year, Richard Forrestel, a CPA and Treasurer for Cold Spring Construction in Akron, New York, testified succinctly on what death tax planning has cost his company:

> "We spend in excess of $100,000 a year in insurance costs and accounting fees to ensure that we have the capital to pay the death tax and transfer our business from one generation to the next. We have diverted enormous amounts of capital and management time to this process. We ought to be buying bulldozers and backhoes built in Peoria, Illinois rather than wasting capital on intangible life insurance policies."

In sum, AGC believes that all the resources spent planning for and paying the death tax should be used more productively to grow businesses and create jobs.

CONSTRUCTION JOB LOSSES

The death tax not only affects the business owner, but also his or her employees. While the death tax rate on a company is 37% to 55%, for the worker who loses a job because of death taxes the rate is in effect an agonizing 100%! AGC's family-owned firms employ on average 40 persons and have created on average 12 new jobs each in the last five years. The death tax, however, can destroy these jobs because firms are often forced to sell, downsize or liquidate to pay this onerous tax. On average, 46 workers lose their jobs every time a family-owned business closes. And every time an owner foregoes the purchase of new equipment because resources have been diverted to pay death taxes, the workers who use and build that equipment are impacted.

Also, remember the effect these family-owned businesses have on their immediate community. They family-owned businesses not only offer jobs, but they are a vital part of every community providing specialized services, supporting local charities, and returning earnings back to the local economy.

ECONOMIC EFFECTS of the DEATH TAX

A most frustrating aspect of death taxation is that after all the countless hours and financial resources spent preparing for and paying the tax, it raises almost no revenue for the federal government! Annual death tax receipts total approximately $23 billion, less than 1.4% of total tax revenue.

Furthermore, the Congressional Joint Economic Committee released a report last year on the death tax that found that this tax "raises very little, if any, net revenue for the federal government." The JEC also concluded that the tax results in losses under the income tax that are roughly the same size as the death tax revenue.

LEGISLATION SUPPORTED BY AGC

AGC appreciates the efforts made by Congress in lowering the death tax as part of the Taxpayer Relief Act of 1997. However, Congress needs to do much more than simply increase the unified credit to help the growing number of family-owned businesses facing the death tax. The construction industry urges Congress to focus on eliminating death tax rates. As stated earlier, the construction industry is capital intensive and even the smallest contractors have lifetime assets that easily exceed the unified credit amount.

In the House, we strongly support H.R. 8, introduced by Reps. Jennifer Dunn and John Tanner, that calls for gradual elimination of the death tax by 5% per year over a period of ten years. We also support H.R. 86, introduced by Rep. Chris Cox, that calls for full and immediate repeal of this tax. We urge Congress to include legislation eliminating the death tax in any upcoming tax legislation.

SUMMARY

The death tax has become an American nightmare at the end of the American dream for family-owned construction companies. Construction company owners work hard to grow their business. They create jobs for people in their community. They pay federal and state taxes throughout the life of their company. But then, when they die, the federal government steps in and takes over half of their company. It is unthinkable in a time of surplus that our government imposes a tax that raises so little revenue while it devastates businesses and kills jobs. AGC urges you to pass legislation to eliminate this terrible tax.

Thank you for the opportunity to present testimony this morning.

BEFORE THE

HOUSE SMALL BUSINESS COMMITTEE

THE TAX, FINANCE AND EXPORTS SUBCOMMITTEE

HEARINGS ON THE ESTATE
TAX BURDENS
ON SMALL BUSINESSES

STATEMENT BY

THE DISTRIBUTION & LTL CARRIERS ASSOCIATION

Respectfully submitted,

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Date: May 14, 1999

The ***Distribution & LTL Carriers Association*** submits this statement on the need to reform one of the most unfair provisions in the tax code, namely the estate and gift tax laws. These code provisions impose an unconscionable tax rate of up to 55 percent on an estate. They often cause severe hardships to family businesses by forcing the sale of assets to satisfy the taxes. The law penalizes lifelong savings and investments based on antiquated social welfare goals.

The Federal government received in 1998 from these taxes about $23 billion, which is about 1.4 percent of its $1.7 trillion in annual receipts. The main beneficiaries of these laws are accountants, tax attorneys and charities who implement complex asset transfer arrangements to legally reduce or avoid these onerous taxes. These costly tax avoidance practices are employed because the tax is perceived as unfair. Unfortunately, the result is often that less sophisticated persons, who do not employ these strategies, face the full brunt of these taxes. Small businesses fall into this unfortunate category.

While a strong case can be made for the repeal of the estate and gift tax laws, our Association recognizes that may not be politically feasible. We concur with Senate Majority Leader Trent Lott, who stated:

> *"The estate tax is a monster that must be exterminated. If it were up to me, we would simply repeal the estate tax in its entirety. Unfortunately, our budget process does not allow us to completely repeal this tax all at once. We must do it in stages."* Cong. Rec. S. 2566 (March 19, 1997).

A number of pending bills would reduce the estate tax burden through various methods and we support their objectives. In particular, we support H.R. 8, "The Death Tax Elimination Act." This bill, co-sponsored by Representatives Jennifer Dunn and John Tanner, would gradually reduce the estate tax rate, by five percent a year, until it is eliminated in the year 2010. This bipartisan bill, with 170 sponsors, is designed to meaningfully remedy this unfair tax by working within the confines of the existing budget agreement, which requires that tax relief measures be paid for. It is a compromise approach designed to obtain majority approval. H.R. 8 has our support.

We also recommend that, as this Committee addresses the issue of reducing the tax burden, it seriously also consider other ways of making the estate and gift taxes simpler, more equitable, and consistent with our other tax rates. Among the options we recommend for consideration, either in conjunction with H.R. 8 or in a separate bill, are:

1. The elimination of a tax when the taxable estate is $10 million or less. Essentially, the unified credit, which now allows a husband and wife to transfer $1.2 million, should be raised to $10 million. We note the estate tax exemption amount in 1916, if adjusted for inflation, would amount to about $9 million in 1999.
2. This nontaxable estate of $10 million should be adjusted annually for inflation;
3. The graduated top rate on taxable estates could be reduced immediately from 55 percent to either 27.5 percent or preferably to 20 percent, which is the capital gains rate. Ideally a fixed, but even lower, rate should apply to the taxable estate if it is not

eliminated altogether;

4. The annual gift tax exclusion of $10,000 per year, per donee should be increased to $20,000; and
5. The double taxation which results when a capital gains or income tax penalty is incurred because estate assets must be sold to pay these death taxes should be eliminated now by some means.

The ***Distribution & LTL Carriers Association*** represents trucking companies engaged in the warehousing, distribution and transportation of freight in small shipments. This so-called less-than-truckload segment of the industry generates approximately $18 billion in annual revenue from interstate transportation services. However, the overwhelming majority of these firms are private, family-owned businesses. They are entrepreneurs. Some involve several generations of families, whose goal, like for all Americans, is to pass on to their children the fruits of their labor. Estate tax reform is a top priority for these companies, since these laws can effectively bar or hinder their ability to transfer their business, which is often the largest asset in their estate.

A 1995 Gallup survey found that one-third of the owners of family businesses expect that some or all the company will have to be sold to satisfy estate tax liabilities. The survey further found that 37 percent of the business inheritors had to shrink or reconstruct the enterprises solely to meet estate tax obligations. This is because of the lack of liquidity or cash to pay the estate tax. See, Cong. Rec. S. 2647 (March 20, 1997).

In 1997, Congress merely tinkered with the estate tax laws in the Tax and Budget Agreement. Essentially, the general estate tax exemption of $600,000, which had remained static since 1987, is now being increased incrementally over ten years to $1 million in year 2006. The $600,000 exemption needed to be increased to $850,000 in year 1997 just to remain current with inflation. Cong. Rec. S. 2565 (March 19, 1997). This change is too little, too slow.

Numerous bills have been introduced in Congress this year and last to provide meaningful estate tax relief. Some bills would repeal the tax immediately. Others, like H.R. 8, would phase it out. Still other bills would raise to $10 million the amount of an estate which would be exempt from taxes. There is no magic to the $10 million level -- although that amount is just slightly higher than the estate tax amount level in 1916, when adjusted for inflation. This level of lifelong savings is not inordinate wealth, which the government should tax again and redistribute through its spending programs. This Committee surely recognizes that the beneficiaries of most estates are the spouse and children of the decedent. It is a transfer of assets among family members. Since the estate taxes do not apply when a spouse is the beneficiary, the taxes are really punitive when the children are the beneficiaries. As Senator Grassley aptly said, "The important thing to keep in mind about estate tax reform is that estates do not pay taxes, surviving families pay taxes."

It is ironic and sad when both the Administration and Congress are attempting to promote education, child care, medical coverage and savings and investments, they allow the estate tax laws to undermine those goals. These assets are often used by the family to provide for their children (estimated cost to be $200,000 until age 21); to pay for college (which can exceed $100,000 for four years at a private university); to provide money for a down payment on a home or pay off an existing mortgage; to cover catastrophic medical expenses; or to provide a supplement for retirement beyond what social security will pay. In sum, a lifetime of savings of $10 million, spread among several family members, is not inordinate wealth today. It is a reasonable benchmark for Congress to consider as a dividing line between taxable and nontaxable estates. This estate reform should not be limited to qualified family businesses, but should be available to all taxpayers.

Moreover, to avoid the annual creep upward of taxation, there should be an indexation of the gross estate exemption for inflation. The existing exemption level of $600,000 per individual, established in 1987, lost over 25 percent of its value to inflation in 1997 dollars. An erosion of the new exemption level should be avoided through an annual inflation adjustment.

In a similar manner, the annual exclusion, which permits gifts of $10,000 per year, per donee that are not subject to the unified credit, should be increased and preferably doubled. The value of this gifting allowance has similarly been eroded by inflation.

The tax rate for taxable estates should also be substantially reduced. One has to go back to the old 70 percent tax rate, imposed on so-called unearned interest income, to think of a more confiscatory rate than the 55 percent estate tax rate. Moreover, the total death tax burden can exceed 73 percent, when assets have to be sold to pay estate taxes and capital gains are realized from the sale. Cong. Rec. S. 2647 (March 20, 1997). This is unconscionable! [1]

The estate tax rate should be reduced and if not ultimately eliminated, it should at least be brought in line with the much lower personal or capital gains tax rates. We believe the property in an estate should be treated like other real or personal property and taxed at the lower capital gains rate of 20 percent, if the tax is not eliminated altogether.

Finally, Congress should devise a method to avoid the double taxation that occurs when assets must be sold to satisfy the estate tax requirements. One means would be to provide that assets receive a stepped-up basis to fair market value when they are devised or bequeathed by will, other legal instruments, or by statutory law upon the death of the maker. Conditions could be placed on this to limit the stepped-up basis to family members or to that portion used to pay estate taxes. There may be superior means to achieve this objective of avoiding dual taxation.

One of the basic tents of a fair tax system is that income should only be taxed once. Income should be taxed when it is earned or realized. It should not be repeatedly taxed by government. The

[1] The current estate tax dates back to 1916, when Congress was seeking to redistribute some wealth from a small number of super rich families. The first permanent estate tax had a rate of 10 percent, and the threshold was high enough to ensure it impacted only a fraction of the population.

current estate tax violates this principle, since at death much of the decedent's savings, or business assets, have already been subject to federal and state taxes. These same assets are then taxes again under the estate tax. Price Waterhouse has calculated that those families who will be liable for the estate tax face the prospect of nearly 83 percent of every dollar being taxes away.

We have not attempted to quantify the revenue loss to the Federal government if our recommendations were adopted. The loss would certainly be less than the full amount of $23 billion now collected annually. Moreover, the net revenue loss (revenue minus expenses savings) would be considerably less. According to Senator Breaux, the Federal government incurs 65 cents in expenses for every dollars it receives under the estate tax laws. Cong. Rec. S. 2566 (March 19, 1997). Therefore, the net revenue loss under these reforms might be $6.5 billion annually. This is an extremely nominal cost to the government, yet will provide significant benefits to many taxpayers. It could be readily paid for with only a fraction of the federal budget surplus.

The ***Distribution & LTL Carriers Association*** appreciates this Committee's consideration of our views. Reform of the gift and estate tax laws is an area where, with relatively modest impact on Federal revenue, Congress can help many families and small businesses continue to provide for their children and grandchildren through the preservation of the business and personal assets that they created through hard work, savings and investments.

Respectfully submitted,

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Date: May 14, 1999

Mechanical Electrical Sheet Metal Alliance

May 12, 1999

The Honorable Donald Manzullo
Committee on Small Business
Chairman, Subcommittee on Tax, Finance, and Exports
United States House of Representatives
Washington, DC 20515

The Honorable Frank LoBiondo
Committee on Small Business
Chairman, Subcommittee on Rural Enterprises, Business Opportunities, and Small Business Problems
United States House of Representatives
Washington, DC 20515

Dear Chairmen Manzullo and LoBiondo:

The Alliance supports the elimination of the estate tax on estate transfers of small businesses.

On behalf of the Mechanical/Electrical/Sheet Metal Alliance (Alliance), thank you for recognizing the need for a hearing on estate tax repeal. Scheduled for May 13, 1999, the hearing "What Would Repealing the 'Death' Tax Mean for Small Business?" is an important step in addressing the burden of estate taxes on the small business community.

The Alliance represents 12,600 construction contractors who are members of the Mechanical Contractors Association of America (MCAA), the National Electrical Contractors Association (NECA) and the Sheet Metal and Air Conditioning Contractors' National Association (SMACNA). Many Alliance members are family-owned small businesses. Alliance firms employ 575,000 union electricians, pipefitters, plumbers, and sheet metal workers.

The Estate Tax Has a Disproportionate Impact on Small Businesses—The Alliance supports estate tax repeal on estate transfers of small businesses because the tax unfairly harms small businesses. Many small and family-owned businesses are asset rich and cash poor. On paper, these businesses appear well off because they own expensive equipment (*e.g.*, trucks). However, cash is often in short supply. When a small business is faced with a significant estate tax bill, often it must sell its equipment to pay the estate tax and keep operating. When equipment is sold, the business becomes less competitive, it cannot perform as much work, and it loses project opportunities. Even worse, in some instances the business must be sold to pay the estate tax bill.

Mechanical Electrical Sheet Metal Alliance

Eliminating the Estate Tax Would Allow Family Businesses to Continue—The Alliance supports estate tax repeal on estate transfers of small businesses because repeal would allow family owned businesses to continue to operate after the owner dies. The failure rate for small and family businesses is disproportionately high: 80% of all start-up enterprises fail in the first 5 years of operation. Of the remaining 20%, the typical life expectancy of the business is 24 years. Fewer than 33% of family businesses survive into the second generation, and fewer than 10% survive into the third generation. There is no justification for levying a tax just because the business is changing ownership due to the death of the owner. The tax code should encourage family businesses to continue from generation to generation.

Eliminating the Estate Tax Would Preserve and Create Jobs—The Alliance supports estate tax repeal on estate transfers of small businesses because repeal would encourage small businesses to create additional jobs and preserve those jobs after a business changes hands. The estate tax is a disincentive for owners of family businesses to expand beyond the estate tax threshold. According to economist William Beach, 145,000 new jobs would be created were the estate tax repealed. Also, money spent on estate planning could be used to create jobs. Small and family owned businesses spend on average $20,000 in legal fees, nearly $12,000 in accounting fees, and over $11,000 on consultants in preparing to pay estate taxes and/or trying to arrange a business succession plan that avoids estate tax liquidation. Therefore, the average small and/or family-owned business spends $43,000 to prepare for paying a tax that may result in the sale of the business anyway. That $43,000 could be used to hire and train new employees, and to grow the business.

The Estate Tax Generates Very Little Revenue—The Alliance supports estate tax repeal on estate transfers of small businesses because the estate tax raises very little revenue. Total estate tax revenue constitutes less than 1.5% of the $1.6 trillion in federal tax revenue collected in 1998. Since 1940, the amount of revenue raised by the estate tax has shrunk as a percentage of the nation's total revenue. Additionally, collecting the estate tax costs almost as much as the tax actually raises. According to a 1995 White House study, approximately 75% of the revenue generated by the estate tax was used on administrative and compliance expenses for collecting the tax.

John P. McNerney
Director
Government Affairs
MCAA

Robert L. White
Director
Government Affairs
NECA

Stanley E. Kolbe, Jr.
Director
Legislative Affairs
SMACNA

STATEMENT OF

MICHAEL COYNE

MEMBER

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

TUCKERTON LUMBER COMPANY

Subject:	Death Taxes
Before:	House Small Business Committee Subcommittee on Taxation
Date:	May 13, 1999

Good morning. On behalf of the 600.000 members of the National Federation of Independent Business (NFIB). I appreciate the opportunity to present the views of small business owners on the subject of estate taxes.

My name is Michael. My family owns and operates the Tuckerton Lumber Company in Surf City, New Jersey.

My grandfather founded Tuckerton Lumber Company in 1932. The company made it through the ravages of the Great Depression and the material shortages of World War II. My grandfather purchased the company from his father and the business has been in the family ever since.

Today, Tuckerton Lumber is a community institution. We have grown over the years to an operation with three locations and a separate Kitchen and Bath business. We have received "The Best Home Center of Southern Ocean County" award, a Reader's Choice Award presented by The Times Beacon Newspaper. I might add, that we have consistently beaten the largest home center chain in the country for this distinction. Tuckerton Lumber Company supports various community efforts, including funding four annual scholarships to graduating high school students.

We also have sixty-five employees. We regard our employees as our best asset and we treat them accordingly. We fully fund and provide for our employees and their dependents full health and dental benefits and a 401(k) plan. On average, our employee turnover rate is very low. One employee has been with our company for thirty four years. Truly, we regard all of our employees as family.

Mr. Chairman, the death tax endangers both my family's business and the jobs of our sixty-five employees. It literally puts seven decades of work, planning, blood, sweat and tears at risk.

My experience with the death tax began just ten years ago when my grandfather-in-law passed away. The bulk of the estate, including the lumber yards, was transferred to my grandmother. Although we had good legal representation and had done the appropriate planning, it became obvious at the time of the transfer that the business would not survive another transition. We were facing an accelerated estate tax rate of 55% should my grandmother pass away.

Since 1980, the business has tripled in size in terms of sales. After my grandfather's passing, we were put in the awkward position of having to worry about increasing the value of the business too much. We have always believed in putting any profit back into the business to keep it strong and healthy and to help it grow. It also helps to have a cushion in order to weather times of economic slowdown.

Another problem we face concerns the land on which our main office and a fully stocked lumber yard is located. It is situated right in the heart of Long Beach Island, a beautiful barrier island that is a highly desired location for summer homes. Real estate values have remained very high for the last twenty-five years, yet moving our main office is out of the question. In order to prepare, we have worked with estate lawyers and accountants to develop a plan for dealing with the estate tax and preserving the family business. In the ten years that have passed, we have invested over $1 million in life insurance policies, lawyers, accountants and other efforts to ensure that when my grandmother passes away, the family business will remain intact.

Mr. Chairman, I have worked for my family's business six days a week often late into the night for the past eighteen years. That's not as long as our most senior employee, and not even as long as my brother-in-law, but it still represents a commitment that has consumed most of my adult life.

That is my story and the story of one family lumber company in New Jersey. My membership with NFIB has exposed me to the experiences of other family businesses. Jack Faris, President of NFIB, recently penned a column that highlighted the efforts of another family lumberyard in Missouri. That family was paying premiums of thirty thousand dollars a year for a life insurance policy against the death tax. I sympathize with that family, but I would point out our premiums were three times as high.

In preparation for this hearing, I was also exposed to several studies, one by the Joint Economic Committee here in Congress, that show the costs of the death tax to families, communities, and the economy far outweigh the revenues the tax raises for the Treasury. That's not news to me. The million dollars my family has invested to prepare for this tax has drained resources that could have been used to expand our business opportunities and create new jobs. Instead of planning for a better business, we're just working to keep what we have.

In 1997, the Taxpayer Relief Act initiated a series of reforms designed to reduce the burden on the death tax on family businesses. I welcome those changes and thank Congress for taking action, but for my business the relief might be described as too little, too late. My grandmother is 91 years old, and though we expect her to outlive us all, increasing the unified credit to $1 million will still leave her estate subject to a tax of millions of dollars.

This business is our life. It puts food on the table of my family and the families of our sixty-five employees. It is simply immoral that a tax, applied at the future death of my grandmother, has the power to take all of that away. We have played by the rules and paid millions in taxes through the years. The death tax would take away in after tax dollars all we have accumulated through the years. Although I represent the third generation involved in the business, we have not squandered what has been passed on to us. Quite the contrary, we have made the business grow through a lot of hard work, discipline and dedication.

I thank the Chairman and members of this committee for holding this hearing and for the opportunity to present my experience.

Statement
of
Thomas K. Zaucha

Submitted to
Rural Enterprises, Business Opportunities and Special Small Business Problems Subcommittee
and
Tax, Finance, and Exports Subcommittee
of the
House Committee on Small Business
in support of
Estate Tax Repeal

May 12, 1999

Chairmen and members of the subcommittees, my name is Thomas K. Zaucha and I am president and Chief Executive Officer of the National Grocers Association (N.G.A.). The National Grocers Association is the national trade association representing retail and wholesale grocers that comprise the independently owned and operated sector of the food distribution industry. This industry segment accounts for nearly half of all food store sales in the United States--more than $200 billion.

Summary of Position

N.G.A.'s retail and wholesale grocers are the backbone of their communities, whether they operate a single store or a larger community multi-store operation. Repeal of the estate tax is N.G.A.'s number one legislative priority. The death tax deserves to die. It does substantial harm to family business owners, their companies, their employees, their communities and to the economy as a whole. On behalf of the nation's independent retail grocers and wholesalers, N.G.A. strongly urges the Small Business Committee to act now to support elimination of the estate tax. Privately-owned retail grocers are facing unprecedented competition from multi-billion dollar mega-chains and supercenter competitors. In order to compete, all businesses need capital to reinvest in their companies. Keeping up with new technology, remodeling and expanding their stores, adding new consumer services, building or buying new stores: all of these business decisions are predicated on having the necessary capital. The federal estate tax of up to 55 percent on the value of their business upon the death of an owner places them at a significant competitive disadvantage. Instead of using this capital to grow the company, it is earmarked to pay taxes.

This anti-family, anti-business tax policy forces many families to face the prospect of selling, going out of business, and denying the next generation of entrepreneurs the opportunity to take the risks and reap the rewards that this industry offers. A week doesn't go by that we don't hear or read about a successful family-owned grocer selling his business. Successful family-owned businesses are making the decision to sell now and pay the capital gains tax, rather than the punitive, confiscatory estate tax.

Legislative Proposals

Representatives Jennifer Dunn (R-WA) and John Tanner (D-TN) have introduced the Estate and Gift Tax Rate Reduction Act, H.R.8, which would phase out the estate tax by reducing tax rates by 5 percentage points each year until the rates are zero. Representative Chris Cox (R-CA) has introduced the Family Heritage Preservation Act, H.R.86, that calls for immediate repeal of the death tax. Numerous other estate tax elimination proposals have been introduced as well.

The important point for the Small Business Committee is to act now in support of estate tax repeal legislation. Privately-owned and operated businesses cannot compete competitively when the federal government makes small business its indentured servant. N.G.A. urges the Small Business Committee members to use their influence with the House leadership and the Ways and Means Committee members to act now to preserve the future of privately-owned and operated businesses before it is too late.

Studies Confirm the Need for Estate Tax Repeal

The case for eliminating the estate tax has been studied to death. Recently, the Joint Economic Committee (JEC) released its study, *The Economics of the Estate Tax*, concluding that the estate tax generates costs to the taxpayer, the economy and the environment that far exceed any potential benefits. Specifically, the report found the following:

- ***The estate tax is a leading cause of dissolution for thousands of family-run businesses. Estate tax planning further diverts resources available for investment and employment.***
- ***The estate tax is extremely punitive, with marginal tax rates ranging from 37 percent to nearly 80 percent in some instances.***

- *The existence of the estate tax this century has reduced the stock of capital in the economy by approximately $497 billion, or 3.2 percent.*

- *The estate tax violates the basic principles of a good tax system: it is complicated, unfair, and inefficient.*

- *The distortionary incentives in the estate tax result in the inefficient allocation of resources, discouraging saving and investment, and lowering the after-tax return on investments.*

- *The estate tax raises very little, if any, net revenue for the federal government. The distortionary effects of the estate tax result in losses under the income tax that are roughly the same size as estate tax revenue.*

- *The enormous compliance costs associated with the estate tax are of the same general magnitude as the tax's revenue yield, or about $23 billion in 1998.*

"The Case For Burying the Estate Tax" by Tax Action Analysis, The Tax Policy Arm of the **Institute for Policy Innovation**, reaffirmed the JEC study, and found that:

> "Estate taxes strike families when they are at their most vulnerable: along with the family member, families can lose what the family member built. High marginal tax rates often force heirs to sell family farms or businesses just to pay the estate tax bill. Eliminating the estate tax altogether would eliminate all these complexities and injustices with no revenue loss to the Treasury. In fact, after ten years, eliminating the estate tax would produce sizeable economic gains, actually increasing federal revenues above the current baseline.
>
> Eliminating the federal estate tax in 1999 would cause the economy to grow faster than in the current baseline, mainly due to a more rapid expansion of the U.S. stock of capital. By the year 2010:
>
> - ***Annual gross domestic product would be $117.3 billion, or 0.9 percent, above the baseline.***
>
> - ***The stock of U.S. capital would be higher by almost $1.5 trillion, or 4.1 percent, above the baseline.***
>
> - ***The economy would have created almost 236,000 more jobs than in the baseline.***

- ***Between 1999 and 2008, the economy would have produced over $700 more in GDP than otherwise.***

The damage that estate taxes do to capital formation further magnifies the loss to society. Doing away with estate taxes would produce positive economic growth effects large enough to offset most of the static revenue loss.

- ***Between 1999 and 2008, elimination of the estate tax would cost the Treasury $191.5 billion.***
- ***But the over $700 billion in additional GDP would yield $148.7 billion in higher income, payroll, excise and other federal taxes.***
- ***In other words, higher growth would offset 78 percent of the static revenue loss over the first ten years.***
- ***By 2006, the dynamic revenue gain from eliminating the estate tax would be enough to offset the annual static revenue loss completely."***

More importantly, N.G.A.'s own 1995 study of its family-owned members confirms the real life need for elimination of the federal estate tax. In the event of the owner's death, 56 percent of the survey respondents said they would have to borrow money, using at least a portion of the business as collateral, and 27 percent said they would have to sell all or part of the business to pay federal estate taxes. Grocers reported that this would result in the elimination of jobs. These findings were similar to those that were conducted as part of a broader industry-wide study conducted by the Center for the Study of Taxation.

Here is what real family-owned grocers have to say about the effects of the estate tax:

From a New Jersey retailer: ***"Estate tax has a negative impact on what should be positive business decisions. Many business owners feel that they cannot expand because they have to pay this tax. Also, Americans should be encouraged to save and invest to plan for their future. With estate tax, the more assets one has with death, the more they have to pay the federal government."***

An Alabama grocer stated: ***"As the only son and heir to our family owned business, our family lives under the constant fear that we will be forced to see or liquidate our business upon the death of my parents in order to pay the estate tax. Inasmuch as my father, who is eighty-five years of age, and my mother, who***

is not far behind, have worked hard to develop a business that could be passed on not only to their immediate family, but as a legacy for their four granddaughters. How would we be able to explain to them that all the hard work and dedication that has been put into the business for the past twenty-seven years was only to pay off the Federal Government because their grandparents passed away."

A Washington retailer writes: ***"I am a small businessman, a grocer, running 2 small grocery stores in Naselle and Ocean Park Washington. My wife and I have been operating this business since 1967. Having recently done extensive & expensive financial planning, I know first hand how badly we (our country) need to consider repealing our Death Tax. Without going into great detail, I will tell you this: Hire a financial planner, hire a lawyer, set up trusts and limited partnerships and buy a huge insurance policy and you <u>may</u> survive a tax burden that is so huge you would have to close your business and sell your assets in order to pay it. The cost for all of this planning for my small business is approximately $20,000 a year. This seams an extreme amount of money. Money that could be going to capital improvements, extra labor dollars, etc., etc."***

An Oregon retailer states: ***"My grocery business was founded by my parents 64 years ago. I am the second generation in the family business. My son hopes to carry the business to the fourth generation. This is highly questionable with death taxes at 55%. If it has to be sold to satisfy the government for the unfair and excessive tax, then another small independent business is gone, along with the jobs my stores offer to this community."***

Conclusion

Numerous studies exist that reinforce the need for elimination of estate tax. Now is the time for Congress to act. Privately-owned and operated retail grocers, as well as other community businesses, face unprecedented competition and the need for capital in order to compete with multi-billion dollar mega-chains and supercenters, such as Wal*Mart. The federal estate tax robs privately-owned entrepreneurs of the necessary capital needed to maintain their competitive position in the marketplace with multi-billion dollar public companies. Failure to act now places the continued diversity of our free enterprise competitive system in serious jeopardy. On behalf of N.G.A.'s members, we encourage the Small Business Committee to support and recommend repeal of the estate tax now.